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## The Sovereign Debt Saga: Italy joins the frenzy

Tuesday morning it was reported that the Italian parliament was working to approve a €40 billion austerity plan by the end of the week in an effort to prevent the European debt crisis from infecting Europe's third largest economy. Although Italy is yet to find itself in a situation similar to that of Greece, it is logical that they would want to stem any potential crisis before it spirals out of control.

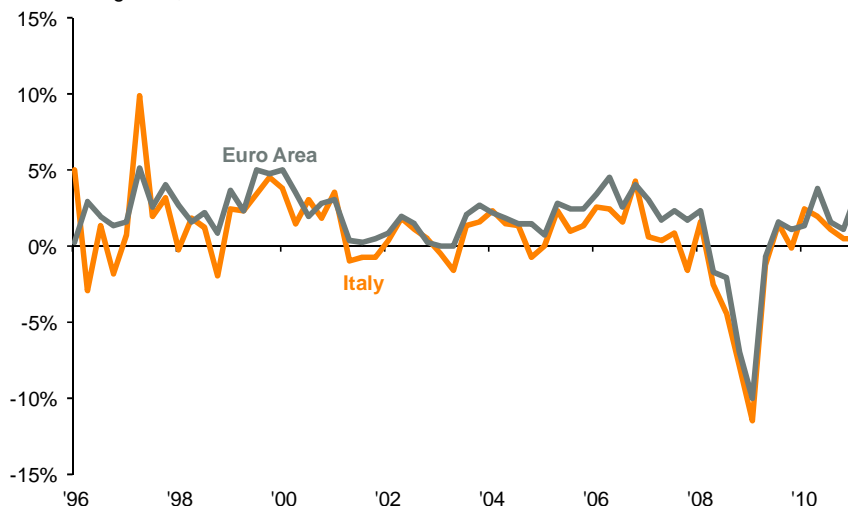
Italy has been plagued by low real growth for a number of years, which has resulted in a high debt to GDP ratio. Additionally, Italian banks are heavily reliant on wholesale funding, and recent stress in the unsecured lending market has highlighted the risks associated with holding these volatile liabilities on their balance sheet. This, along with the fact that Italian banks hold a substantial amount of Italian government bonds, has generated fears of a sovereign debt issue in Italy and pushed Italian government bond yields higher. While austerity measures can help gain control of the situation, it is important to understand how Italy arrived at the current juncture, and the implications of further stress in the Italian bond market for all the players involved.

### How did we get here?

The slowdown in Italian economic growth over the past decade has resulted in an elevated debt to GDP ratio. From 1996 through the first quarter of 2011, the Euro area averaged a real annualized growth rate of 1.7%, while Italy averaged a mere 0.8% annualized growth:

**Chart 1: Euro Area GDP Growth Has Outpaced That of Italy**

Real GDP growth, % saar

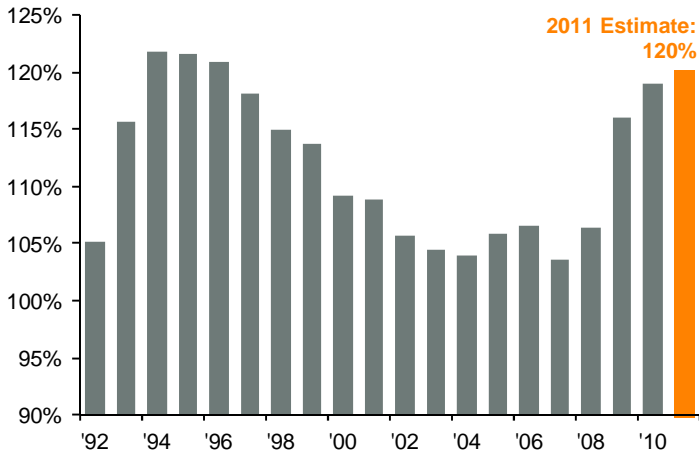


Sources: Eurostat, ISTAT, J.P. Morgan Asset Management.

This weak real growth has been driven by low competitiveness, which is primarily a function of low productivity growth. As a result of this lackluster growth, Italy's debt to GDP ratio has remained well above 100%. Additionally, while market concerns about debt levels had been moderate due to the fact that Italy has shown the ability to maintain a primary budget surplus over the past couple decades, concerns about the Italian banking system have made this an issue that now must be addressed.

The best solution to the growing debt issue is for Italy to generate real growth in its domestic economy, but given that this problem cannot be rectified overnight, it is encouraging to see the Italian parliament taking steps toward implementing austerity measures sooner rather than later. However, recent developments in the Italian bond market have generated concerns about both the viability of the banking system, as well as the possibility of the European debt crisis spreading to Italy.

**Chart 2: Gross Italian Government Debt**  
Percent of GDP

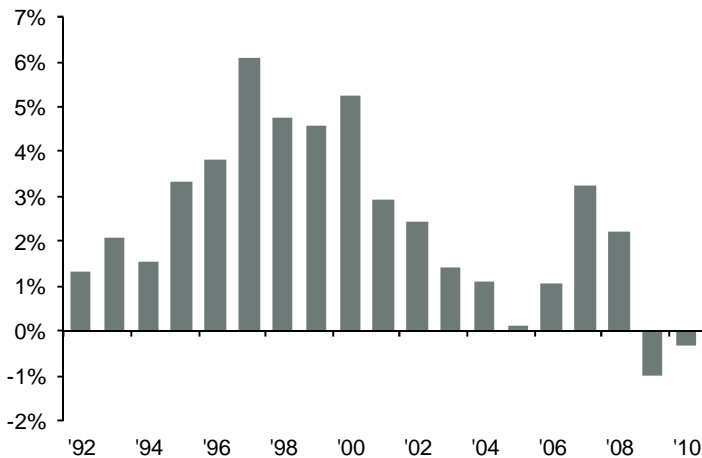


Sources: IMF, J.P. Morgan Asset Management.

**What to watch**

Recent stress in European unsecured interbank markets has generated concern due to Italian banks' heavy reliance on wholesale funding. Wholesale funding is when banks get loans from other financial institutions, rather than from people who are keeping their money at the bank, to help finance their operations. While wholesale funding increases the funds that banks have available to lend, these liabilities have a propensity to be far more volatile than retail deposits, which tend to be much "stickier." As shown below, the loan to deposit ratio for Italian banks is higher than for those of Germany, France and Spain, and given their reliance on wholesale funding, suggests that many of their loans may be financed with wholesale funds.

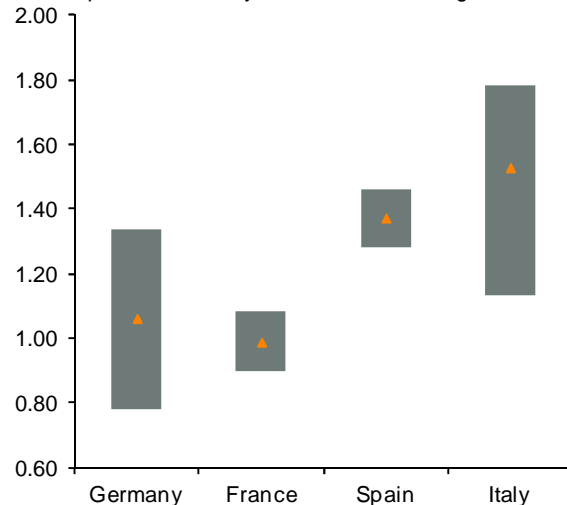
**Chart 3: General Government Primary Surplus/Deficit\***  
Percent of GDP



Sources: IMF, J.P. Morgan Asset Management.

\* Primary surplus/deficit is defined as the difference between a government's revenues and expenditures, less interest payments on its debt.

**Chart 4: Loan to Core Deposit Ratio at European Banks**  
Core deposits covered by insurance, asset-weighted\*



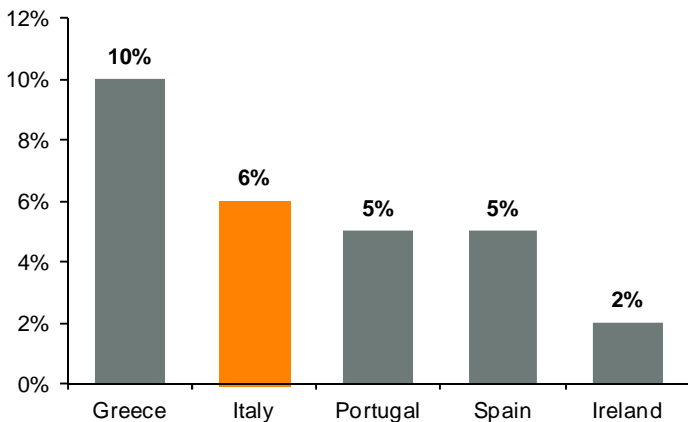
Sources: J.P. Morgan, J.P. Morgan Asset Management.

\* Grey bar highlights the interquartile range, which is the difference between the third and first quartiles. Loans are net of loan loss reserves.

Thus, the issue at hand is actually more about the banks than it is about sovereign risk. For example, money market funds may decide that they are unwilling to lend to Italian banks, as they feel inadequately compensated for taking on additional risk. Although relying on these liabilities as a source of funding has worked historically, with unsecured lending markets coming under pressure, economic growth weak, and debt to GDP ratios elevated, there is presently little room for error should these assets become increasingly volatile. Proper policy responses likely consist of reducing reliance on wholesale funding; however, restructuring for less reliance on wholesale funding takes time, and would force the Italian banks to rely on raising additional retail deposits or raising equity in order to increase the amount of capital at their disposal.

However, the reliance of Italian banks on wholesale funding is only part of the story. Although they avoided a real estate bubble and may hold higher quality assets than other European banks, elevated holdings of Italian government bonds have left Italian banks vulnerable, as it has increased the sensitivity of these banks to their own sovereign, and risks the creation of a vicious cycle. As shown in the chart below, Italian bank holdings of their own government bonds as a percent of assets is second to Greece, and higher than those of Portugal, Spain and Ireland:

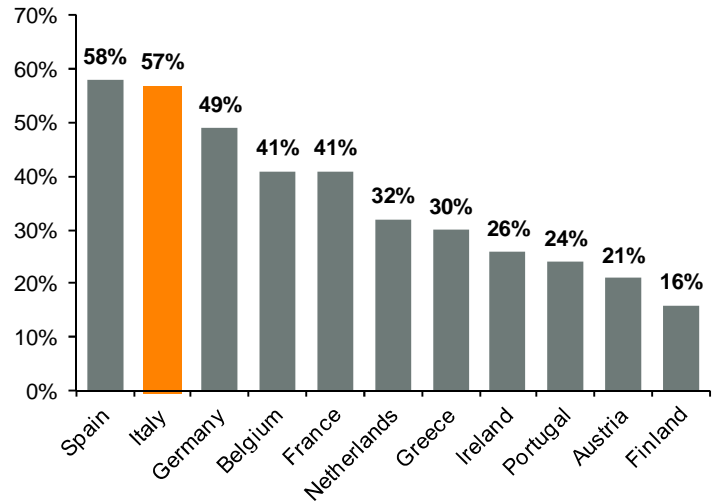
**Chart 5: Bank Holdings of Domestic Sovereign Debt**  
Securities issued by governments as a % of total bank assets



Sources: ECB, J.P. Morgan, J.P. Morgan Asset Management.

With Italian bond yields pushing higher due to market pressures, the appetite of Italian banks to sponsor their domestic bond market may wane due to the fear of further increasing their sensitivity to their sovereign. As shown in the chart below, Italy has traditionally had a strong domestic investor base; as such, it should be kept in mind that this strong domestic investor base makes Italy less vulnerable to international contagion, assuming these investors are willing to maintain their holdings of sovereign debt.

**Chart 6: Domestic Sovereign Debt Holdings**  
Percent of sovereign debt held by domestic investors



Sources: ECB, J.P. Morgan, J.P. Morgan Asset Management.

**Investment Implications**

If Italy were downgraded or demand for Italian debt were to subside, it could send yields higher and prices lower, sparking a vicious cycle whereby Italian banks no longer provide the same support for their domestic debt market. This could cause yields to rise further, and prevent Italy from being able to tap the capital markets for additional financing due to an increase in interest expense. While there is the possibility that the ECB could “print Euros” to purchase debt on a broad basis around the periphery, Europeans are likely reluctant to monetize the debt of sovereigns that cannot access the capital markets due to doubts about their solvency.

Although it remains possible that peripheral debt could be monetized, Europeans would likely prefer a fiscal solution to a fiscal problem, as widespread monetization of peripheral debt would more likely erode confidence in the single currency than create a sustainable solution to the crisis. A more sustainable solution would not monetize the debt, and could entail the use of transfers or guarantees from one of the stabilization funds to help alleviate some of the pressure on the peripheral economies. These transfers or guarantees could involve the issuance of Euro area bonds, the proceeds of which would be used to redeem the existing outstanding debt of the peripheral countries that have come under fire. While this would replace unwanted and risky bonds with safer, more desirable bonds, the taxpayers of larger economies like Germany and France would be left on the hook if the peripheral countries were unable to repay these loans. That being said, these options are clearly superior to an outright default or credit crisis. Thus, while there are a number of viable solutions to the current predicament that could be employed, this situation should be monitored closely, as an Italian sovereign debt crisis could have much larger implications for the European Union and economy than was the case with Ireland and Greece.

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