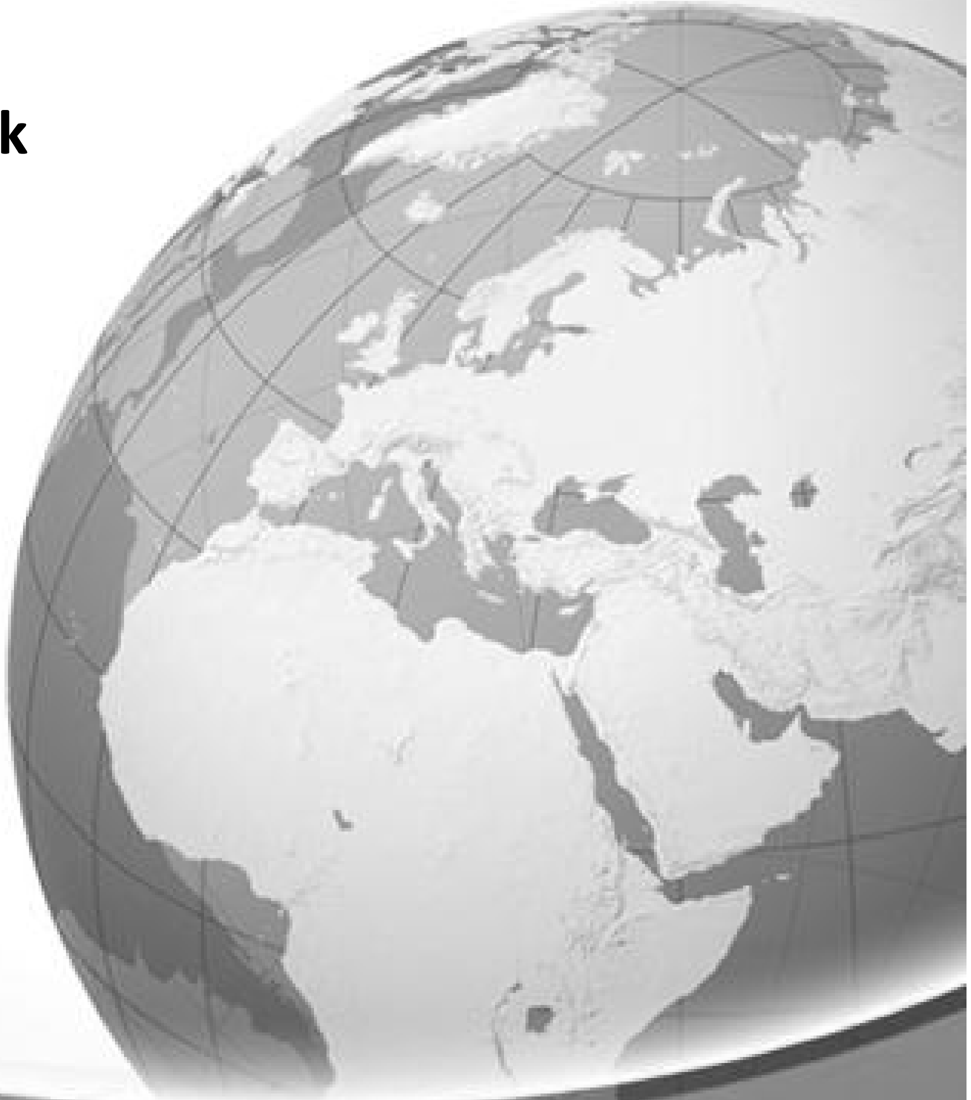
# VAKIFBANK GLOBAL ECONOMY WEEKLY

## Is Italy Going To Be The New Weak Link After Greece ?



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Vakıfbank Economic Research

***Introduction...***

*Debt crisis which has threatened Euro Zone countries for two years, caused concerns about Italy and Spain after other PIIGS countries. Although Italy is the third largest economy of Euro Zone, due to its high public deficit after Greece, weak macro economic datas and political instability, concerns over Italy have increased recently. In this study, factors behind Italy debt corncerns and their impacts on markets are analysed.*

# Concerns about Italy’s economy supports fears about it’s credit note...

| Credit Ratings | | | |
|---|---|---|---|
| | End of 2009 | End of 2010 | July 2011 |
| Greece | A2 | Ba1 | Caa1 |
| Portugal | Aa2 | A1 | Ba2 |
| Ireland | Aa1 | Baa1 | Ba1 |
| Spain | Aaa | Aa1 | Aa2 |
| Italy | Aa2 | Aa2 | Aa2 |

Source: Moody’s

- Banking sector and debt crises first started in Greece and affected Ireland and Portugal afterwards. Concerns about Spain and Italy have been increased recently and made macroeconomic instability more clear in the Euro Zone countries.

- Therefore international credit rating agencies downgraded these two countries’ long term sovereign credit ratings.

- Moody's which does not change Italy’s credit note since 1996, said that it may cut Italy's sovereign credit rating from Aa2, because of concerns about economic growth and risks about the public debt.

- Moreover when the political instability and reducing voter’s support has taken into account, decreasing budget deficit may be difficult for the government.

## Italy's weak growth performance and high government debt maturing in less than one year...

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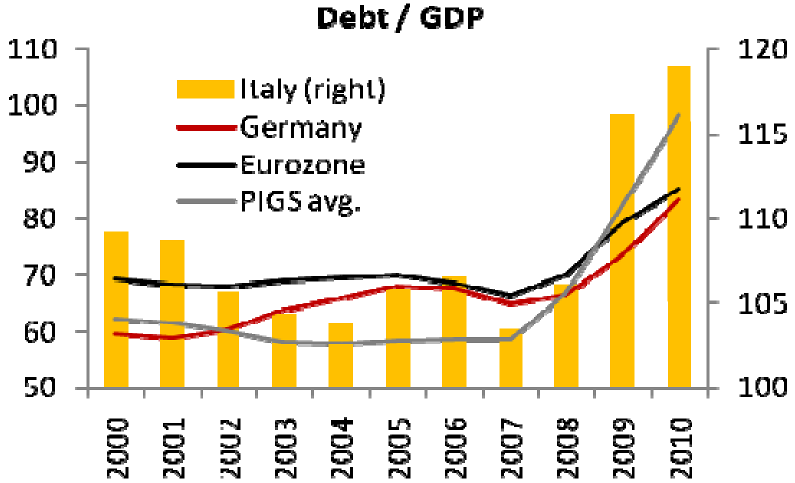
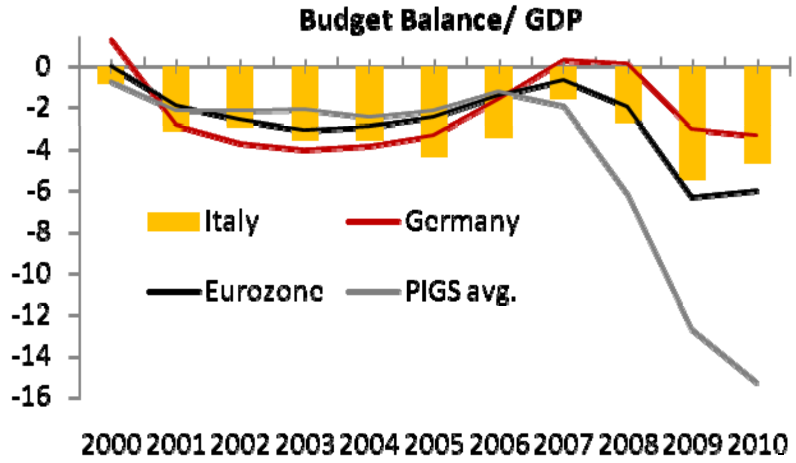



Source: Bloomberg

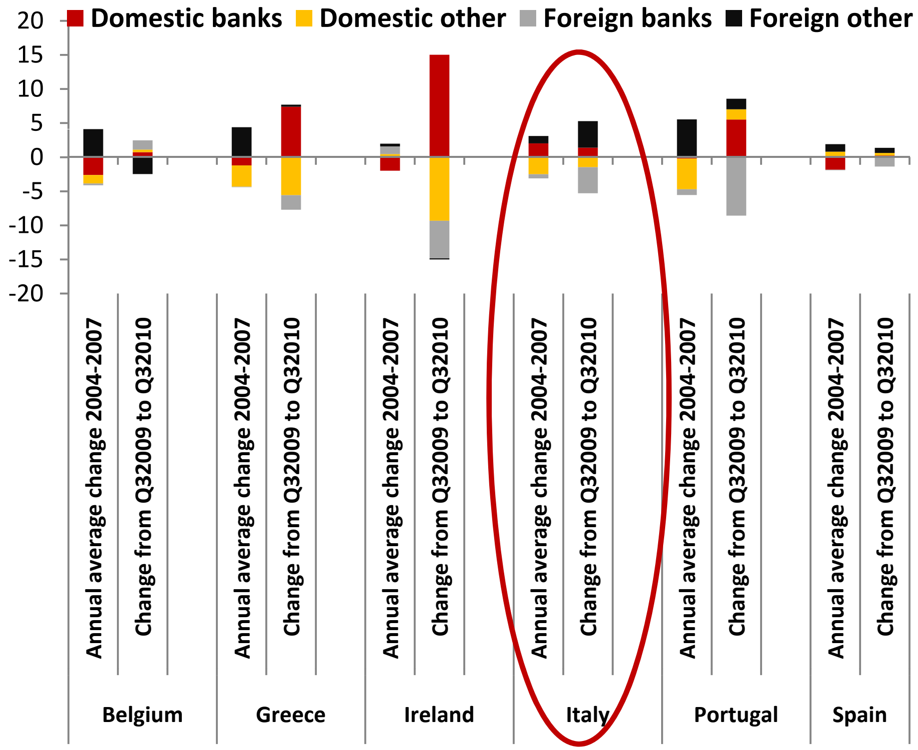



Source: Bloomberg

- Despite of its positive budget performance, concerns over Italy has increased recently.
- The weak growth performance of Italy is one of the important reasons behind the concerns. While Eurozone grew by 1.4%, Italy grew by 0.6% in ten years which was under the PIIGS average growth rate.
- Although Italy has much better budget performance than other Eurozone countries, rapidly rising debt stock as well as the weak growing performance are the other main concerns over Italy.
- Another main problem of Italy is its short term domestic debt repayments. While other Euro zone countries' debt maturing in less than 1 year amount to $140 billion, Italy's short term debts amount to $350 billion.

# Another reason behind Italy debt contagion fears is the vulnerable banking sector in Italy...

**Change in Government Debt Holdings/Total Debt**




Source: IMF Global Stability Report April 2011

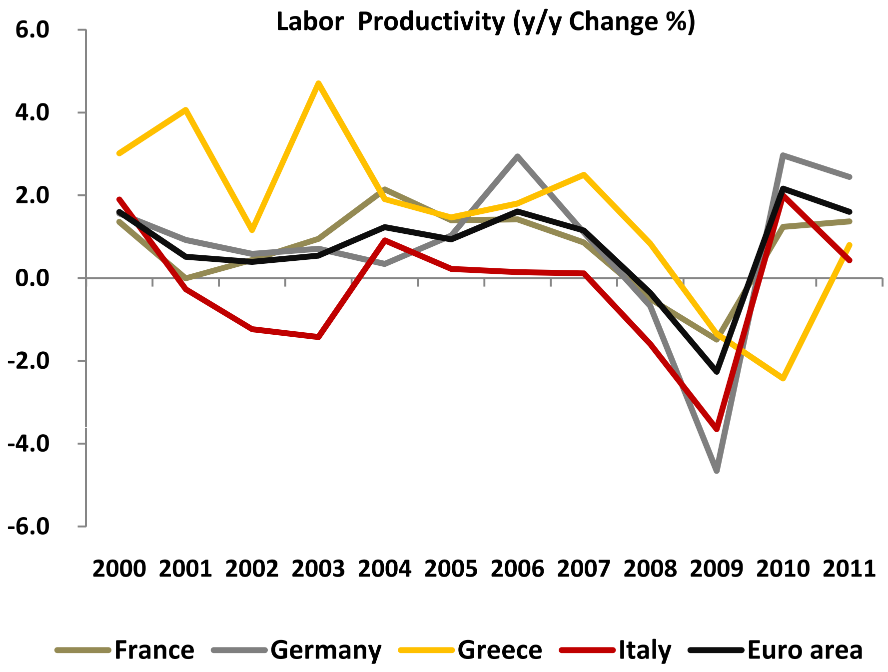
| Country | European Banks' Exposure to Government Debt (€ Billion ) |
|---|---|
| Italy | 176.8 |
| France | 37.7 |
| Germany | 27.8 |
| UK | 13.7 |
| Spain | 10.8 |
| Greece | 0.1 |
| Portugal | 0.1 |
| Ireland | 0 |

Source: Goldman Sachs

- Italian banks' elevated holdings of government bonds increases their sensivity to their own sovereign risks. As it is seen in the graph above, between 2004-2007 domestic banks and domestic other financial institutions were the mainly supporters of domestic government bond market. But after 2009Q3 foreign banks and foreign other financial institutions' holdings of Italian government bonds have been increased.

- Due to this high foreign ownership ratio, any debt crisis problems in Italy would have major implications for European countries. As European banks total exposures to Italy are more than six times higher than to Greece, Italy's debt problems causes concern in Europe.

# Low productivity is one of the important factors behind Italy's sluggish growth...




Source: OECD

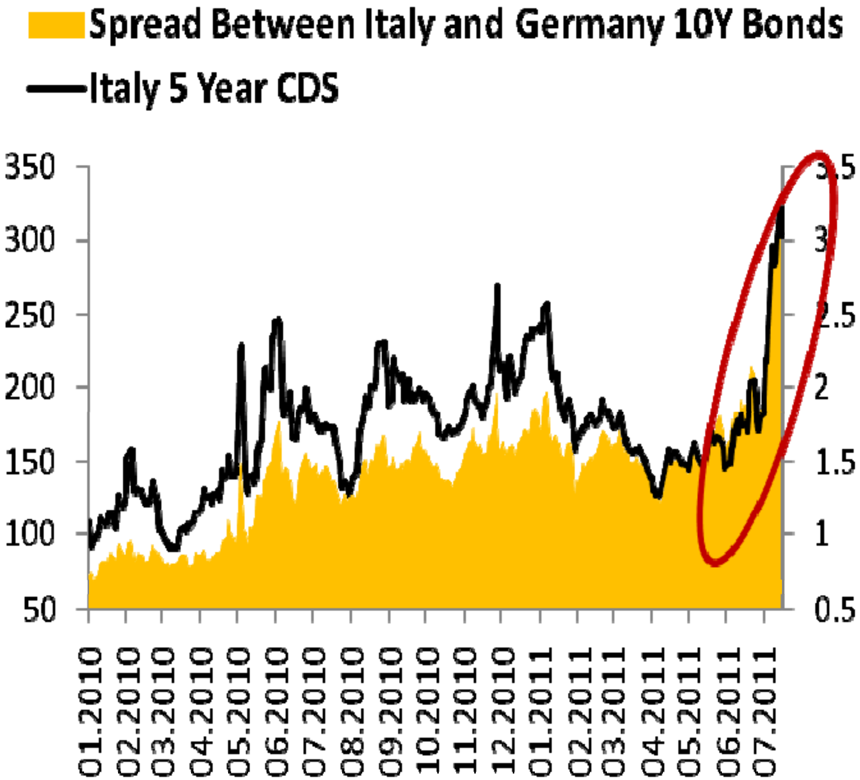
- Italy's weak economy, low growth potential and low productivity makes it hard for the government taking steps to improve economy.

- One of the main reasons behind Italy's weak growth potential is the corporate structure, with many family-controlled small firms. As these firms seem to find it difficult to adopt themselves to the rapidly changing globalized economy they have low competitiveness.

- It is seen in the graph LHS, since 2000 labor productivity in Italy has decreased sharply compared to Greece and has not recovered yet.

- It is obvious that government need to take some measures to increase productivity and also long run growth outlook.

## Concerns about Italy negatively affect markets...



Source: Bloomberg

- Italy's 5 year CDS rates and 10 year bond yields increased sharply in July due to high public deficit and concerns about banking sector.
- While Italy's 5 year CDS increased to 26.8% at the end of 2010, it increased 75% only in July and reached 320 level.
- This shows that investors confidence has been damaged about Italy.
- On the other hand bond yields have increased and reached to 5.97% in July.
- Moreover spread between Italy and Germany 10 year bonds increased to 3% which was the highest level.
- The global economy and markets may continue to follow Italy in the next period.

*Italy and Japan…*

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# Italy

- **Debt/GDP:** 119%
- **Current Account / GDP:**-3.5%
- **Over 65 Years:**25.4%
- **10 years bonds:** 5.27%

# Japan

- **Debt/GDP**: 220.3%
- **Current Account Deficit / GDP:** 3.6%
- **Over 65 Years (%):** 21%
- **10 years bonds:** 1.09%

**WHY**

- Different production structure
- Heterogenity in monetary union
- Currency tool for restore for competitiveness.

Source: IMF, Bloomberg, "Italy versus Japan" Paul Krugman

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