Debt Woes Spur Worry Over Fate Of the Euro

A sell-off of government bonds as investment funds reassess their risks. Absent growth, the two countries might have to leave the common currency.

By LANDON THOMAS Jr.

Even as global stock markets climb, worries are building among investors that long-simmering debt troubles in Greece and Italy will put additional strain on the euro.

Over the past year, aggressive bond buying by the European Central Bank and encouraging signs of economic growth across Europe have helped the eurozone overcome a series of political jolts, including Britain electing to quit the European Union and Italian voters rejecting the proposals of a reform-minded government.

Yet with the central bank expected to eventually unwind its purchases of government bonds and other assets, investors are increasingly becoming concerned about how Europe — and Germany, in particular — can cope with escalating debt pressures in Italy and Greece.

The result has been a sell-off of European government bonds as investment funds reassess the risks of holding such securities. In Italy, for instance, some hedge funds are making direct bets that the prices of Italian bonds will collapse.

The yield on Italy's benchmark 10-year note — which moves in the opposite direction of its price — has doubled to 2.3 percent since late last fall. The yield on the equivalent Greek note has jumped to nearly 8 percent from 6.7 percent at the beginning of the year.

Mario Draghi, the European Central Bank's president, promised in summer 2012 to do whatever it took to save the euro, but the debt burdens of Italy and Greece have become progressively worse amid the stagnation of their economies.

Italy's debt as a share of its economic output has risen to 133 percent from 123 percent during that period. In Greece, debt has increased to an expected 183 percent of the country's total economy from 159 percent.

These figures highlight a harsh economic reality: Just as an individual will struggle to pay off a punishing credit card bill if her salary stays flat or falls, a country cannot reduce its debt pile without expanding its economy.

And with Italy and Greece held back by fiscal constraints required by the euro's rules and not expected to generate enough growth in the future, the only alternatives are a restructuring of debt or an exit from the common currency.

"The common themes here are high debt, low growth and dysfunctional banking systems," said Ashoka Mody, a former top economist at the International Monetary Fund who is writing a book about the birth of the currency pact. "Now these problems are not only Europe's problem; they are a global problem."

While these issues have not been secret — they were at the heart of the eurozone's debt crisis in 2010 and 2011 — they are drawing closer now scrutiny because of reports making the rounds among traders and economists.

For investors interested in making specific bets against Italy, two studies that conclude the country is unlikely to be able to repay its debts in full have attracted the most attention.

Astellon Capital, a hedge fund based in London, argues in its analysis that some form of restructuring is essential for Italy, given the inability of the country's economy to grow. The Astellon study highlights the fact that most of Italy's debt is governed by local law, which, in theory, would make it easier to restructure.

As Greece proved in 2011, having your debt governed by local law — rather than by courts in London and New York — makes it easier to achieve terms in a debt restructuring that favor the government instead of international investors.

The Astellon report also notes that the E.C.B. and sickly Italian banks have been the main buyers of Italian government bonds over the past three years. That buying has driven prices higher, sending yields tumbling to a low of 1 percent from 6 percent.

Many American investors got in on the buying, too, and for a period, Italian bonds were among the more popular investment plays for yield-hungry mutual funds in the United States.

Now, even with the recent rise in yields, a view is taking hold that a yield of 2 percent is not sufficient given the risk that Italy may be forced in the future to impose a haircut on its private sector creditors — or, in a more extreme scenario, have to exit the euro.

"There is only one buyer of these bonds, and that is the E.C.B.," said Bernd Ondruch, Astellon's managing partner. "The risk-reward scenario to owning Italian bonds right now is just dreadful."

Also drawing the attention of investors with skeptical views toward the eurozone is a paper issued by Mediobanca, the Italian investment bank.

Like the Astellon study, the Me-

diobanca report highlights just how little Italy has benefited from being in the euro: Growth has been zero, and the economy's competitiveness as an exporter has deteriorated.

In the meantime, Italy's debts have ballooned, with only Greece paying out more to creditors as a share of its broader economy (6.1 percent compared with 5.5 percent for Italy).

"Our conclusion is that a voluntary debt re-profiling, an Italexit scenario, or a combination of the two will inevitably gain traction with investors given the lack of growth and/or significant discontinuity in the eurozone macro-economic politics," the report's authors write in a summary of their findings.

The International Monetary Fund also weighed in this week, publishing a long-awaited analysis of the challenges the Greek economy still faces.

The report has been the focal point of heated disagreement between the fund and Europe in terms of what Greece needs to do to get back on track. The fund has argued that, in addition to needed reforms, European governments must provide debt relief to Greece for the country's economy to recover fully.

"Growth, competitiveness and debt sustainability have not been restored," the fund concludes in its evaluation — a powerful indictment given that it has now been seven years since the first Greek bailout.

The Europeans, and Germany in particular, have rejected this notion, contending that Greece's economy is improving and that as long it keeps spending tight, the government will be able to make good on its debts.

But Marcello Minenna, a financial economist and one of the authors of the Mediobanca report, says the dispute between Europe and the I.M.F. misses a larger point.

As he and his colleagues lay out in their study, it is a historic inability of poorer countries in the currency bloc to grow and reach their full potential that lies at the root of the continuing drama over Italian and Greek debt.

"These countries are not growing due to lack of investments — they are caught in a mouse trap," Mr. Minenna said. "Without a major restructuring of eurozone, there is just nothing you can do under these rules."