FINANCIAL TIMES

Data 12-06-2019
Pagina 20
Foglio 1

Bonds price in heightened risk of Italy leaving euro

Marcello Minenna

Markets Insight

Italy is the only country across the eurozone not to really benefit from the big rally in government bonds this year. The main culprit? The risk of exiting the euro-area, which is reflected in a permanent increase in Rome's cost of borrowing.

If we look across bonds of 10-year maturities, the effects of the rebalancing of portfolios towards sovereign bonds are impressive. The yield on the German Bund is about 45 basis points lower than at the turn of the year, pushing it in negative territory while the French equivalent has lost 60bp. In Spain, bond yields are about 85bp lower while even Greece is down about 160bp.

But for Italian bonds, there is a loss of just 40bp or so from already-high levels.

The performance of Greek debt deserves particular attention, in the context of Italy. Both countries are carrying lots of debt (182 per cent of GDP for Greece and 133 per cent for Italy) and are plagued by low growth, bad productivity and subdued inflation.

The first factor to consider is that the Greek government bond market is very thin on liquidity. Just a few big deals by a few important players are enough to move prices.

Of a total debt stock of about €400bn, only €71bn — less than a fifth — is traded on the secondary market, since the majority is frozen in the balance sheet of the European Stability Mechanism.

Of the remainder, about €40bn has been deeply buried for years in the balance sheets of Greek banks, insurance companies and pension funds. Only about €30bn is available for trading.

After years of very limited interest in the market among investors, Greek banks increased their government bond holdings by about 30 per cent (€5bn) in January this year. Meanwhile, among foreign investors, US and French investment funds and banks have re-entered the market, heavily increasing their exposure to Greek sovereign risk.

Financial stability seems to justify this renewed interest in Greek debt. Defying some very bleak expectations, the government has been able to obtain a primary budget surplus of 3.9 per cent in 2017 and 4.4 per cent in 2018. Recent estimates envisage a stable budget surplus of about 1 per cent a year, after debt-servicing costs, until 2022.

A favourable picture emerges, too, from the reading of spreads on credit default swaps, which is the premium paid to buy protection against a default of Greek debt. Despite thin trading volumes, these instruments indicate an 80 per cent fall in the cost of insuring five-year bonds against default since 2016.

> Financial stability seems to justify a renewed interest in Greek debt, defying very bleak expectations

It is illuminating to examine the differences between the new CDS contracts based on the legislation introduced in 2014 by the International Swaps and Derivatives Association and the old contracts based on 2003 laws.

The new CDS contracts insure the holder against the redenomination of the debt in a new currency while those based on the previous standard of 2003 do not. Obviously, the premium of the newer kind of insurance should be higher than the older one and the difference could be seen as a measure of the probability that investors are assigning to an exit from the single currency.

For Greece, this premium differential has flattened out at about 40bp after a sharp decline following the last troika bailout. According to markets, Grexit risk is all but dead. The situation for Italy, however, is strikingly different.

In a more liquid CDS market, the gap between the two insurance premiums jumped from 20bp to 80bp in May 2018 after the coalition between the anti-establishment Five Star Movement and the far-right League.

Since then, the gap has fluctuated above that level in response to government initiatives — such as the "citizens' income" for the poor and the proposal to create a parallel currency — and conflicting projections about the economy.

The insurance premium against Greece's default risk (a five-year CDS price of about 300bp), then, can be broken down into three components.

The first, the "generic" risk of being a peripheral country like Spain, counts for about 50bp and the second comes from the idiosyncratic risk connected to the country's economic weaknesses, which for Greece amounts to about 210bp. What is left, at about 40bp, reflects the risk of exiting the euro.

For Italy's CDS premium of about 230bp, 100bp is accounted as a compensation for idiosyncratic risks and about 80bp for the risk of Italy leaving the EU. This is more than a third of the total insurance premium while, for Greece, the impact of this risk is much lower.

The market, then, has reassessed Italy's exit risk: a phenomenon deeply connected with the presence of a new, conflict-ridden government unwilling to comply with EU budget rules.

Marcello Minenna is head of quants at Consob, the Italian securities market regulator, and the views expressed are his own

Ritaglio stampa ad uso esclusivo del destinatario, non riproducibile.