

Can Italy and Spain survive rates of 6-7%?

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No. 279, 27 July 2012

The sentiment that the euro is now in real danger is based in large part on the widespread conviction that interest rates of 6-7% are simply unsustainable for both Italy and Spain. However, a closer look at the fundamentals suggests that both countries should be able to live with this level of interest rate for quite some time, but only if they mobilize domestic savings, which remain strong in both countries. For Spain, in addition, some debt/equity swaps are needed.

The nature of the fiscal problems differs between the two countries. In Italy the main problem is the roll-over of the stock of debt, whereas in Spain the debt level and the roll-over needs are lower, but the deficit is much larger. Moreover, the Spanish government faces large contingent liabilities from its banking sector. The only way to deal with this problem would be to transfer most real estate assets held by the weak Spanish banks to a European entity with much lower funding costs.

Italy

A strong and credible fiscal adjustment is being implemented, which should keep the 2012 deficit to between 1% and 2% of GDP, with structural balance within reach.

But the government has to refinance each year the equivalent of about 15-20% of GDP of old debt falling due; and at present it is paying 6+% on ten-year bonds (less on shorter-term ones). Many observers argue that this is not sustainable.

However, the Italian government should be able to survive a substantial period of high interest

rates – as it did in the 1990s when interest rates were in the double digits for several years. (See my [analysis](#) of this period and what is different today.)

The distribution of tasks should be simple: the Italian households should finance their own government by buying its debt, and the European Central Bank (ECB) should prevent a collapse of the Italian banking system.

A first element to keep in mind is that the higher interest cost affects only the debt that is maturing and needs to be rolled over. Higher interest rates thus feed only very gradually into higher costs for the government. Moreover, while the risk premium is very high, one has to take into account that German rates have gone down considerably. The average cost (over all maturities) of new debt is still below 6% for the Italian government, about 2 percentage points higher than before the crisis. Given that roll-overs amount to about 20% of GDP each year, the present constellation of higher rates increases interest costs for the Italian government only by about 0.4% of GDP for each year it persists.

But the key element of survival is that the new high-cost debt should be sold mostly to Italian residents, preferably unleveraged players like households. In this way the higher cost of debt service will not be a burden on the country, but just a redistribution of income between (domestic) savers and taxpayers. (Given Italy's modest net foreign debt (only about 25% of GDP), it is natural that a high private-asset/income ratio provides the counterpart to a high debt/GDP ratio. See the

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annex for a decomposition of the net foreign asset position by sector for Italy.)

By contrast, to the extent that the new, high-cost debt instruments are sold to foreign investors, they constitute a burden on the entire economy because they lead to a deterioration in the current account. This should be avoided by using regulatory and other levers to entice Italian savers to shift to Italian government debt – typically BOTs (short-term bonds) and BTPs (Italian treasury bonds with maturities of 3, 5, 10, 15 and 30 years). (On the difference between domestic and foreign debt, see my [Policy Brief](#)). At present already less than 40 % all Italian public debt is held by foreigners. If the proportion of *new* debt bought by domestic savers could be increased to about 80% over time, most public debt would migrate back to the country. Since Italian households dispose of very large foreign assets, they should be able to refinance the roll-over of their government by just selling their foreign bonds (which now yield close to nothing). In other words, this could happen even without any need for additional household savings.

Experience has shown the importance of a domestic investor base in times of crisis. During the 1990s, the interest burden for the Italian government was almost twice as high as it is today (11% of GDP then, compared to 5.5-6% of GDP today). But this was sustainable because most of the debt was held by residents (the famous ‘BOT people’).

Existing foreign assets should thus be sufficient to finance the rollover of Italian government debt for quite some time.

However, the country still has an ‘external financing gap’ given that at present Italy still runs a current account deficit of about 3% of GDP, somewhat under €50 billion per annum (less next year). If foreign investors refuse not only to finance the government, but also Italian private-sector borrowers, the gap would need to be covered from elsewhere. In practice this means that Italian banks would need to obtain more funds from the ECB.

In an ideal world, it is clearly not the task of a central bank to finance regional current account imbalances. But it would still be preferable for the ECB to provide the Italian banking system with continuing access to its normal monetary policy operations to the tune of €50 billion annually,

rather than see the country being subject to a sudden stop. (See my CEPS [Commentary](#) on why the ECB has no choice but to effectively become the ‘central counterparty’ for the euro area banking system.)

The stability of the Italian banking system now seems assured given that the ECB has made 3-year funding available through the LTRO (this is especially important given that supervisors will not allow Italian banks to give medium-term credits to SMEs if they refinance themselves only with short-term funding). The relaxation of the collateral requirements that came with the LTRO is even more important. Banks can now use any performing loan to obtain funding. This is crucial for a banking system that has conservatively stuck to its basic business of lending to the real economy and thus until recently had more difficulties finding eligible collateral on its balance sheet.

All in all, it seems that Italy should have a good chance to survive even a prolonged period of high risk premia if it can mobilize its domestic savings.

Spain

The case of Spain is similar in terms of the flows of foreign financing needs given that the current account is also only about 2-3% of GDP – but very different in terms of the stock of foreign debt. The flows seem manageable since Spanish households still have a solid savings rate. Given the moderate current account deficit, Spanish residents (preferably non-leveraged ones) should be able to absorb a high proportion of the deficit that needs to be financed.

However, the Spanish private sector does not have enough (net) foreign assets to finance the roll-over of the existing stock of public debt. The roll-over needs are much smaller than for Italy since Spain’s public debt is (still) smaller and of more recent vintage, implying that the direct impact of higher interest rates on government debt service is not immediately threatening.

Fundamentally, however, the situation is much more difficult for Spain since the net foreign debt of the country is around 90% of GDP or roughly €900 billion, most of which is owed by the government and banks.

Given that Spanish households do not have sizeable net foreign assets, they cannot finance the roll-over. It follows that secondary-market

purchases by the European Stability Mechanism (ESM) might be required to substitute the foreign holders of Spanish public debt who want to exit, apparently at almost any price. The high yields on *bonos* (Spanish bonds) also constitute an occasion to extract some 'PSI' (private sector involvement), especially at the longer end. Ten Spanish bonds now trade below 70% of face value. If the ESM were to buy especially at the longer end, it might be able to buy a face value of €300 billion for less than €210 billion. The ESM could then communicate to the markets that in case there are problems it will insist on seniority only for the amount of its own cost (in the example here €210 billion), not the face value of the bonds it has bought (€300 billion). In this way the seniority problem could be much reduced. Perhaps private investors will even value the potential reduction in the debt to be serviced (in case a restructuring has to take place) as more important than the seniority of the ESM. Secondary market purchases by the ESM at a steep discount might thus help to stabilize the market while still respecting its seniority.

The real estate sector constitutes obviously a second problem area in Spain. Here again the main problem is the need to roll over foreign financing. For an analysis of the Spanish boom and bust, see <http://www.ceps.eu/book/spanish-hangover>

The dodgy subordinated debt and preferred shares that some legacy institutions from the *cajas* sector (Spanish savings banks, e.g. Bankia) had sold to their own customers have attracted a lot of attention and generated immense political problems at home. But this is an internal problem, involving Spanish depositors, these particular banks and the Spanish government. Foreign investment in the real estate sector had been mostly on a secured basis, e.g. via *cedolas* (covered bonds, the Spanish version of *Pfandbriefe*). The vast majority of Spanish mortgages are still performing.¹ But this is of little solace to Spanish banks, given that these mortgages are usually very long term (remaining life of 20 to 30 years) and at very low interest rates, usually short-term Euribor plus 150 basis points. With Spanish banks now facing Euribor plus 650 basis points, these 'good assets' would actually constitute a considerable

burden for the banks if they had to refinance them as the existing stock of *cedolas* matures.

Over the last year, Spanish banks have thus rolled over their *cedolas* almost exclusively via 'own issues', which they then can refinance at the ECB with only a small haircut at such low rates (now 0.75%) that they still earn a positive carry. The ECB can do little to avoid financing this 'carry trade', but it might actually be appropriate to do so if it had enough detailed information to be able to judge both the soundness of the banks and the quality of the underlying collateral (part of this is already foreseen in the Spanish MoU). Access to this detailed, usually confidential, information should be given to the ECB immediately. This will happen in any event once the decision of the June 28th summit to create a 'system of supervision' under the ECB has been implemented. But this might take until next year, whereas the ECB needs the information right now in order to be able to its job properly.

Moreover, the successors to the *cajas* have on their balance sheets hundreds of billions of euros worth of real estate assets of two types: developments in various stages of completion and apartments/houses from mortgages in default. How much value there is in these assets is difficult to say, but it is clear that they cannot be profitable at a financing cost of 6-7% in an environment of falling house prices and stagnating rents. However, a European institution that is able to take a long view and has a low funding cost might find considerable value in these assets as many developments might then be finished or used for different purposes. And the rent income from houses/apartments should be sufficient to cover funding costs if these assets can be transferred at an appropriate discount and refinanced at less than 3%.

What is needed is thus to create as rapidly as possible - perhaps initially under the auspices of the European Investment Bank (EIB) or one of the special purpose vehicles (SPVs) of the European Financial Stabilisation Mechanism (EFSF) - a European real estate management vehicle (EUREM) that could bid for Spanish (and also Irish) assets taking a long-term view. The key for the success of such an operation would be to assemble enough real estate expertise to properly value and then manage these assets. A number of private sector real estate management companies already exist. They might manage the assets under

¹ The available prices on Spanish RMBS indicate that delinquency rates are expected to remain manageable.

the auspices of the EUREM. The financing could then be distributed and perhaps securitized with the senior tranches sold to the private sector and the junior tranches via the EIB (in turn issuing project bonds) or even EU Structural Funds

Spanish banks could then sell their directly held real estate assets (auctions are also possible, but it is unlikely that there would be many bidders in the current environment) to the EUREM. This would alleviate funding pressures on the Spanish banking system and would effectively represent a debt for equity swap, reducing the debt of the country. It should be possible to reach an investment volume of the EUREM in the Spanish real estate sector of about €200 billion, thus providing another substantial contribution to refinancing the country's foreign debt.

Annex: The balance sheet of Italy

In a crisis the structure of the balance sheet matters. That is why it is useful to look at the international investment position of Italy today. Overall, the balance sheet of Italy looks rather healthy, but has two weak spots.

Healthy

The overall foreign indebtedness of the country is limited. The sum of past current account balances equals only about €200 billion, or less than 15% of GDP. The official statistics of the 'net international investment position' (NIIP) of the country show a somewhat worse picture in that Italy officially owes about €400 billion (about 25% of GDP) more to foreigners than the country has assets abroad – hardly an unsustainable position, compared to Greece with a net foreign negative asset position of over 100% of GDP, or even that of Spain, which is close to 80% of GDP. This moderate foreign indebtedness is also reflected in the fact that net income payments to foreigners amount to less than 1% of GDP.

.... but vulnerable.

Unfortunately it seems that the country has leveraged itself by issuing debt to pay for equity investment abroad. The net debt (defined as the balance of assets and liabilities other than equity) of the country is thus about €700 billion (45% of GDP) because Italians own about €300 billion more in equity assets abroad than foreigners own in Italy (FDI in Italy has been notoriously scarce).

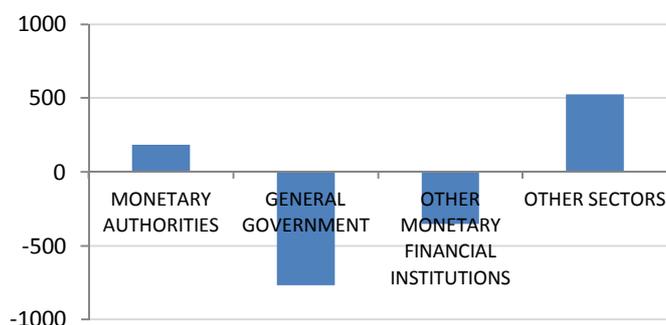
This makes the country of course more vulnerable to a liquidity run. To some extent Italy is thus in a similar position as an investment bank which might be very well capitalized, but nevertheless can get into trouble when the debt cannot be rolled over and comes due, but the equity investment cannot be liquidated quickly.

The net foreign position of the main sectors also shows vulnerabilities:

The foreign debt of the public sector is close to €800 billion, and the banks also have a net negative position of around €330 billion. It is thus not surprising that Italian banks have been hard hit when foreign financing dried up. In the short run, Italian banks will have little choice but to rely increasingly on the ECB.

By contrast, the non-financial private sector (households and non-financial enterprises) has a strong net positive foreign position of €530 billion (30% of GDP), which is actually larger than the negative position of the banks.

Figure 1. Net international investment position by sector, as of March 2011 (€ billion)



Source: Bank of Italy.

For the time being, this has not prevented the sell-off in the Italian government bond market. However, the fact that the private sector has a large pool of foreign assets implies that the pressure on the government bond market could be much reduced if Italian savers could somehow be persuaded to increase their investment in (relatively high-yielding) domestic assets.

This strong position of the Italian private sector will also become important as the government reduces its deficits. Households will be able to partially offset the higher taxes and lower transfers by selling some of their own assets. This should limit the negative impact of the inevitable austerity measures on demand.