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# Who holds Italian government debt? A Primer

Daniel Gros

The debt to GDP ratio of Italy remains at 130% of GDP, the second highest in the euro area. Moreover, under current policy settings it is poised even to increase, rather than fall, over the next few years. This outlook has led the European Commission to start a debt-driven excessive deficit procedure against the country. The key issue is not so much the deficit, which has remained below 3% of GDP so far, but the fact that public debt is not falling. Whether or not this procedure will go beyond its early stages is not clear. But it is certain that in the end, all the European authorities could do is to impose a fine of a few decimals of a percent of GDP.

The real arbiter of Italian public finances thus remains the financial markets where the Italian Treasury has to sell its debt to finance both the current deficit and the roll-over of past debt coming due.

In this context, the holdings structure of government debt becomes important. Knowing who are the ultimate holders of Italian public debt is crucial for answering two important questions:

1. What is the proportion of 'patient' holders, and those likely to trade frequently?
2. Who would carry the losses should there be a default?

A first indication, potentially concerning both questions, should be the distribution of debt between domestic and foreign holders. Italy is a high savings country and some Italian policy makers like to compare their situation to that of Japan where the debt-to- GDP ratio is even higher (220% of GDP on a gross basis, albeit 'only' 130% of GDP on a net basis). This huge debt burden is not perceived as a threat to financial stability because the overwhelming majority of Japanese public debt is held in Japan. But is Italy similar in this respect?

Daniel Gros is Director at CEPS.

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Like Japan, Italy has run a current account surplus of 2-3% of GDP for some time. This indicates an excess of domestic savings. However, an important difference is that Japan has been running a current account surplus for decades, accumulating a net foreign asset position of roughly one half of (annual) GDP, whereas the net foreign asset position of Italy, even if headed towards zero, is still negative at present. This is why only less than 7% of Japanese Government Bonds are held by foreigners.[1]

The widely repeated assertion that Italy's debt is mainly domestic is often based on the observation that Italian households hold very large financial assets. The net wealth of Italian households is estimated to amount to about €10 trillion, of which over one half, or over €5 trillion is in financial assets, which is more than twice total public debt of around €2,250 billion. The claim that most public debt is domestic appears thus plausible at first sight. However, a closer look at the data reveals the need for two important qualifications.

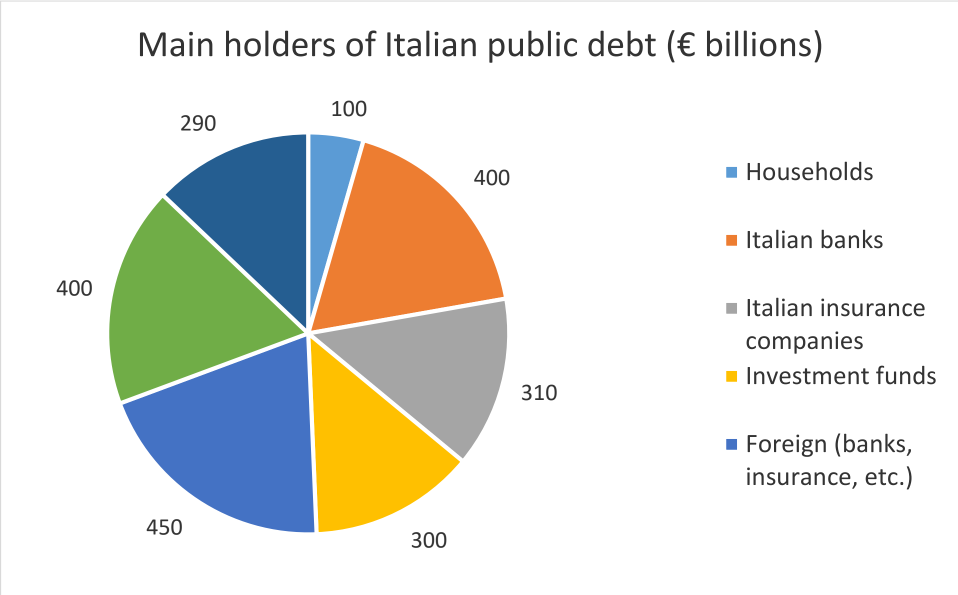
First of all, Italian households own very little government debt directly. All sources agree the direct holdings amount to only about €100 billion, or 5% of total public debt. The explanation is simple: a lot of debt is held by Italian financial intermediaries (banks, insurance companies, etc.) whose ultimate beneficiaries are Italian households. It would be difficult to change this pattern quickly, making it challenging for any government to suddenly try to appeal to households to buy a substantial share of the debt if other buyers were no longer interested. Another implication of the dominance of financial intermediaries is that the Italian public might read about interest rates and risk premia going up or down, but they do not immediately perceive the implications for their own financial situation. For example, the government assures the public that bank deposits and bonds are safe, but given the exposure of banks to the government it is clear that any default by the government has to lead to losses for the banks' clients.

The second observation is that the share of the debt held by Italians (whether directly or via their financial intermediaries) is somewhat lower than often assumed. In order to see this one has to take a closer look at the data and disentangle some categories that are often lumped together.

An often forgotten part of public debt comes in the form of loans. Italian banks do not only hold large amounts of government bonds; they also have on their books about €290 billion of loans to general government. Little is known about the rates charged by banks on these loans, mostly to local and regional authorities.

Subtracting the loans from the total one arrives at about €1960 billion (or 116% of GDP), which comes in the form of securities or tradable debt issued by the central government. This is debt sold on the market, and which must be periodically rolled over. The 'spread' or risk premium applies mainly to this debt.

[1] One needs to distinguish between bonds (JGB) and T-bills (maturity less than 1 year, often only 3 months). Foreigners hold most of Japanese T-bills, but the overall amount of T-bills outstanding is only 1/10th of JGBs. For Italy one also finds that the share of foreign holdings is much larger for BOTs than for BTPs.




*Source*: Own calculations based on Banca d'Italia statistics.
*Note*: Total public debt (debt of all levels of the Italian government together) amounts to about €2,250 billion (about 131% of GDP).

As mentioned above, only about €100 billion of the debt in the form of securities is held by households directly. This was different in the past, when interest rates were much higher and people held large amounts of debt directly in their deposits. However, with today's lower interest rates, few households own Buoni Ordinari del Tesoro (BOTs) or Buoni Pluriennali del Tesoro (BTPs). The situation is very similar across Europe as households in most countries own very little public debt.

The bulk of tradable debt is thus held by financial intermediaries.

About €400 billion is held by banks. The total exposure of the Italian banking system towards all levels of the Italian government is thus €690 billion. This means that Italian banks are by far the largest source of finance for the Italian government to whom they lend more than to SMEs. Bank deposits are supposedly safe. But, in reality, bank deposits are to a considerable degree indirect loans to the government.

Next come a group of other Italian financial intermediaries, which in most statistics are lumped together, namely insurance companies and (domestic) investment funds. However, these two types of institutions represent very different holders: insurance companies are fairly patient holders, which operate under EU rules and do not have to immediately mark their holdings to market.

Investment funds, by contrast, mark their holdings to market daily and tend to trade frequently. They hold about €300 billion (mostly long term securities).

Regarding investment funds, the official statistics distinguish between domestic and foreign funds. But many funds officially domiciled in Luxembourg or Ireland have mainly Italian clients. This implies that one should add together all the holdings of Italian public debt of those investment funds with Italian households as their ultimate beneficiaries. The resulting number is about €300 billion.[2]

Investment funds, which have mainly non-Italian residents as their beneficiaries, own about €450 billion. This is the part that is usually counted as foreign debt. By this count, foreigners own only about 22% of the total.

But this is not all. A key, and often misunderstood, debt holder is the Banca d'Italia. Most of the about €400 billion of BTPs held by the Italian central bank were acquired under the quantitative easing programme of the ECB, known officially as the Public Sector Purchase Programme or PSPP.

The Banca d'Italia holds these €400 billion of BTPs under its own responsibility. Moreover, the Banca d'Italia is part of the public sector and pays back to the Treasury most[3] of the interest it receives on these securities (now about 0.4 % of GDP annually). This implies that the BTP holdings of the Banca d'Italia are no longer part of public debt. Instead, one has to consider the liabilities of the Banca d'Italia as also being Italian public debt. The liabilities of the Banca d'Italia, which have increased the most since it started buying BTPs under the ECB's quantitative easing, are its liabilities towards the rest of the Eurosystem (i.e. towards the ECB and the other national central banks) under the Target II payments system, which now amount to about €400 billion.

This means that, if one consolidates the Banca d'Italia with the Treasury, as one must, this adds a further €400 billion to the amount the Italian public sector owes to foreigners.[4] Added to the €450 billion of investment funds holdings mentioned above this makes a total of about €850 billion being owed to foreign entities. As a share of public debt, this is thus around 45% – still below one half, but almost twice as high as commonly assumed.

The PSPP was advantageous for Italy because it transformed debt subject to market forces (BTPs) into opaque obligations towards the rest of the euro area, which, for the time being, carry no interest. Moreover, the Target II debt does not need to be rolled over. It thus constitutes a particularly stable source of (indirect) funding. One needs to keep in mind that the cost and the availability of Target II imbalances cannot be controlled by the Italian government. The cost could rise rapidly if the ECB decides to increase interest rates and the volume will be reduced if the ECB decides to do so. But both these risks seem remote at present.

[2] This assumes that all Italian-domiciled investment fund holdings of around €150 billion have Italian households as the ultimate beneficiaries and that around €150 billion of foreign-domiciled investment funds (in Luxembourg and Ireland) are also owned by Italians.

[3] Every year, the Banca d'Italia essentially transfers to the Treasury all of its income minus costs and the dividend paid to its private shareholders (and minus considerable additions to its risk reserves).

[4] There is an interesting difference to Japan here: the Bank of Japan owns almost one half of all JGBs, but its liabilities are deposits by Japanese banks, i.e. domestic debt.

Returning to the two questions posed above, the following conclusions emerge:

1. What is the proportion of 'patient' holders, and those likely to trade frequently?

The share of Italian public debt subject to potentially frequent trading that can lead to volatility in the market is essentially that owned by investment funds. It does not really matter whether they are owned by Italians or foreign residents. The managers of these funds have a fiduciary duty towards their clients. This means that if they see a potential for a default, even if small, they are likely to sell. The total owned by investment funds is about €750 billion. This implies that only about a third of all Italian public debt is directly subject to daily trading and market pressure.

Moreover, most of the Italian public debt held abroad is held inside the euro area, mostly by investment funds domiciled in Ireland or Luxembourg, and by insurance companies. This implies that the influence of 'Anglo-Saxon' hedge funds on the spread is likely to be minimal.

2. Who would carry the losses should there be a default?

This is difficult to predict. Given that the largest share of debt is held by Italian financial intermediaries any default would risk destroying the financial system, which in turn would have very high economic costs. It is thus unlikely that the debt held by banks and Italian insurance companies could be subjected to a hair-cut. In Greece the government also had to recapitalise its banks by the amount they lost on their holdings of Greek government bonds.

Moreover, unless the country leaves the euro area and decides to inflict losses on its EU partners, the €400 billion of Target II liabilities cannot be touched. This means that the debt that could be subject to a hair-cut would be limited to only about €850 billion – the €750 billion held by investment funds and the €100 billion held by households directly. Under these conditions, any substantial reduction in overall debt would imply a proportionally much larger loss for these non-protected holders. For example, cutting debt by 20 percentage points of GDP (equivalent to a reduction in public debt of about €350 billion) would require investment funds and households to take a 40% loss on their holdings. This might be one of the reasons why the spread reacts continuously to news about the intentions of the government concerning deficits and the debt. In the case of a default, their losses might be very large indeed.

However, most households are probably not aware of their own exposure since they are unlikely to follow closely the amount of Italian government debt in their holdings of investment funds. This adds to the political 'disconnect' already mentioned above: although most Italian government debt is still owed to Italians, the wider population does not grasp the potential cost to themselves of a default. The opposition to policies that keep the risk alive is thus much weaker than it should be.

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