European Financial Crisis Worsens; Italy Next?

As U.S. politicians scramble to defend themselves against raising the federal government's astronomical debt to an even higher level, Americans may be seeing the reflection of their own future in the grim picture of insolvency across Europe.

The so-called PIGS nations of the European Union (Portugal, Ireland, Greece, and Spain) are all caught in a vise: on one side, spiraling debt and obligations which can be serviced only through borrowing, and on the other, the increasing costs of borrowing resulting from profound doubt in the minds of potential buyers of government debt instruments that bonds can be repaid.

The PIGS have now become the PIIGS with the addition new member Italy, as on August 3 the yields of 10-year Italian government bonds hit a new high. (There is an inverse relationship between a bond's price and its yield.) The government sold €3.9 billion of bonds at a yield of 5.77 percent, significantly higher than the 4.94-percent yield in bonds sold as recently as June 28. The Bank of Italy's Deputy Director-General Ignazio Visco told the Italian parliament that each rise of 100 basis points in the cost of borrowing would be equal to a reduction in Italy's GDP by .2 percent in the first year and .4 percent and .5 percent in the second and third years.

According to *Spiegel* online,

> The symptoms are all too familiar. The risk premium on Italian government bonds reached a new high on Monday, stocks fell and the Milan stock exchange restricted short-selling as a precaution.
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> Italy has suddenly become the focus of international investors' attention. New doubts about the stability of the Rome government and a deep skepticism about the country's finances have combined to form a dangerous mixture. The national debt is at 120 percent of gross domestic product (GDP), the second highest in the euro zone after Greece.

Bond rating services have taken an increasingly dimmer view of Italy's ability to pay its bills. Standard & Poor's, for instance, has expressed doubt about the Italian government instituting real fiscal reform — a typical precursor to actually lowering the credit rating.

S&P's primary credit analyst Eileen Zhang noted that the reason for her firm's opinion was weak growth in the Italian economy, adding, "As a result, we believe that Italy's prospects have diminished to a reduction of its debt." Moody's has also expressed a cautious view of the Italian public debt situation.

Not surprisingly, the Italian government — like those of the other PIIGS nations — has taken umbrage at the opinions of the bond rating services. Italian Economy Minister Giulio Tremonti declared that his country is now on a better financial footing than it was last December, when Standard & Poor's gave a positive assessment of the country's debt quality. The conditions since that time, he insisted, "not only remained the same, but have improved in some areas."

The Italian national debt is already €1.6 trillion — three times greater than the national debt of Greece, Portugal, and Ireland combined. Although the situation is not as stark as in the other PIIGS nations, the very size of the Italian debt is setting off alarms.

A financial meltdown in Italy, the eighth largest economy in the world — larger than India, Russia or Canada — would create greater waves across the eurozone than would an economic collapse any of the other PIIGS nations. Compounding the problem is the seepage of fiscal woes into neighboring countries which have heretofore been reasonably stable.

Nicholas Spiro at Spiro Sovereign Strategy noted: "It's worrying that this time round it's the 'soft' core of the eurozone – in particular Italy and Belgium – that's bearing the brunt of contagion." Belgium still has no government, almost 14 months after its last general election — a world record. If Belgium is partitioned, analysts wonder who will pay the sovereign debt. Government bonds in Belgium are at an all-time high.

Harvinder Sian, a senior bond analyst at the Royal Bank of Scotland, summed up the consequences of rising bond yields in countries with shaky debt problems: "This has all the features of a self-fulfilling crisis. The rise in yields looks pretty relentless and it doesn't look as if the politicians are any nearer to getting ahead of the curve."

Analysts point out that European Union politicians created this crisis by using taxpayers' money to buy votes with cushy pensions and entitlements. As witnessed recently in Greece, public-employee unions have become a virtual army of protesters and rioters, who blame traditionally friendly politicians, eurozone officials, bond rating services, and even other European nations — notably Germany — for their fiscal woes.

The flip side of the coin is that nations with sound fiscal policies, such as Finland, are increasingly unwilling to accept blame or offer help to spendthrift countries such as the PIIGS, which have lived beyond their means for decades. Not only are nations blaming fellow eurozone nations for the financial crisis, but different populations within nations are blaming each other as well. For insteance, the Flemish separatists in Belgium want out of the hybrid nation because they believe that their own productivity and relative thrift are being used to support the country's Walloon– and Belgian French-speaking population.

Critics observe that the notional governance of the European Union has proven useless in many cases, as when the Bank of Ireland simply began to print euros itself to pay bonuses. The only stipulation the European Union made was that it be given notice, and Ireland gave that notice. Observers are noting that increasingly desperate nations may revert to these monetary policies of Weimar Germany and simply print money to solve their problems. Only one of the PIIGS would have to begin the process to seriously to unravel the whole system, and the hyper-inflation of the euro would affect most of Europe.

This dangerous cocktail is compounded by the rising population in Europe of young Muslim men who have no interest in working to save older native Europeans from the collapse of their nations and their welfare systems. In nations such as Greece, the so-called "far right" is taking to the streets to protest the large immigrant population.

The clock is ticking in Europe, and no one seems yet ready to consider the real solutions to its economic woes: strict immigration control, substantial curtailment of government pensions and entitlements, reduction of the tax burdens on the productive, the stabilization of currency by connecting it to precious metals, and the reassertion of national rights.

Photo: The European Central Bank