The Eurozone Continues to Unravel

The bond market shifted its attention to Italy on Monday, driving interest rates on its 10-year bond to a record-high 6.66 percent, the highest since the country entered the union in 1999 and perilously close to the "bailout" levels reached before Ireland and Portugal were forced to ask for help from the European Central Bank. Said David Ader, head of government bond strategy at CRT Capital Group, "We've seen one European bank and one U.S. brokerage fail. We know there are strains for French banks. We [were] wondering how long it [would] be before Greek default worries spread to Italy and Spain. In a situation like that, money managers are going to decide simply to take their risk down." The resulting sell-off in the bond market flowed over to the Euro as well, as it came down from its Greek-euphoria highs of last week by nearly 3 percent, and it could lose 6 percent by the end of the year according to the CEO of Intermarket Strategy in London, Ashraf Laidi.

The problems in Italy are nearly an order of magnitude larger than in Greece, with an economy six times larger than Greece's, and its government debt of $2.6 trillion approaching 120 percent of its gross domestic product. This is way beyond the financial ability of the European Financial Stability Facility to bail it out.

Part of the problem is Italian Prime Minister Silvio Berlusconi's lackadaisical attitude towards the impending inability of his government even to service the interest on its debt. In comments over the weekend, Berlusconi said that "the restaurants are full, the planes are fully booked and the hotel resorts are fully booked as well." As noted by two Deutsche Bank analysts, "The problem is that with a potential political crisis looming, Berlusconi seems to be fairly relaxed and at the same time not in any hurry to step up the pace of reforms. Unfortunately for the market it doesn't seem that Berlusconi agrees with the need for rapid action."

In the meantime, the European Central Bank continues to buy up Italian debt in order to keep interest rates down, but that is only a short term answer. Nick Stamenkovic, fixed income analyst for RIA Capital Markets in Scotland, said, "The last thing the ECB wants is to be seen buying Italian bonds while they [the Italians] are doing nothing in response. [Berlusconi] is clearly an obstacle to get reforms in place. If they removed him, that would clear the decks." Berlusconi is impervious to the pressure being applied to remove him, writing on his Facebook page that "the reports of my resignation are without foundation."

That foundation crumbled on Tuesday following the failure of his party to muster enough votes to pass a key budget provision. Following the vote, Burlosconi said he would resign, leaving the future of Italy's government, the Euro, and the Eurozone itself in question.

All of this is sounding very much like a Greek reprise, only with much larger numbers. As Thanos Vamvakidis, head of European strategy for Merrill Lynch, put it: “Italy has much more systemic implications. Italy is too big to fail, [and] too big to save.”

Photo: Italian Prime Minister Silvio Berlusconi