

Commentary

# Italian Government Debt Selloff Highlights Global Concerns

By: SEI Investment Management Unit

- Italy has replaced Greece at the center of the European crisis as a result of its government debt (the third largest in the world) selling off sharply, with yields<sup>1</sup> now at levels that may prove unsustainable in the long run.
- While the Italian government's fiscal challenges are not as immediate as Greece's, the selloff throws future financing in question, as it may not be able to roll over its liabilities without some form of assistance.
- Market reaction to Italy's recent bond issue (the highest yields in 14 years) suggest that this issue has not been put to rest

## Italy Spoils the Party

In the days after markets celebrated what appeared to be a viable new rescue plan for Greek government finances (see our November 2011 commentary, "Has Europe Finally Rescued Itself? Probably Not."), the market for Italian government debt was thrown into crisis. Yields crossed the seven-percent threshold for a short time, and are still at levels that many economists believe are unsustainable, meaning that Italy could eventually be faced with its own debt default crisis. Yields over comparable German debt (a perceived safe haven) have roughly tripled since the beginning of 2011, indicating that risk aversion toward Italy has risen dramatically, as shown in Exhibits 1 and 2.

### Exhibit 1: Italian Government 10-Year Yield



Source: Bloomberg  
Rate is composed of generic Italian government bonds' pre-tax yields, based on the current bids offered in the market.

### Exhibit 2: Italian 10-Year Government Spread



Source: Bloomberg  
Spread is the difference between the current market yields on Italian and German 10-year government debt. A rising spread indicates higher investor risk aversion toward Italian government debt.

Despite the fireworks, the background story on Italy hasn't changed. As credit rating agency Standard & Poor's noted in a downgrade of the government's credit earlier in the year, Italy is an advanced economy with high per-capita gross domestic product (GDP) and financially stable corporate and household sectors. The Italian government currently runs a primary surplus, meaning that its revenue exceeds expenditures excluding interest payments on existing debt, and unlike Greece, it does not face any immediate risk of insolvency. Its interest payments and the maturity schedule of its existing debt are currently manageable. But it also has one of the highest debt-to-GDP ratios among developed nations, rigid labor markets, flat productivity growth, and a significant percentage of its economic activity takes place underground to avoid taxes and regulations. As a result, its debt, especially in light of worsening demographic and economic prospects and the possibility of political gridlock,

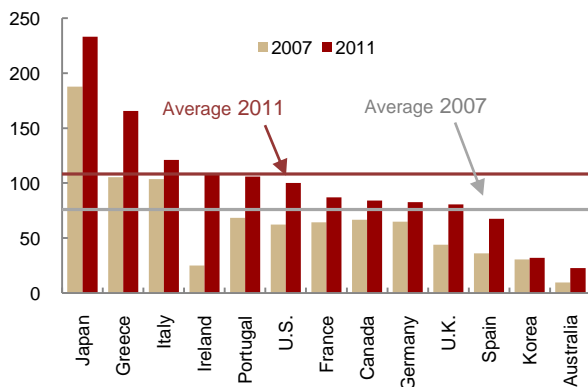
presents a serious long-term fiscal challenge (see Exhibits 3 and 4). If Italy loses the confidence of private-sector government-debt buyers—and judging by recent market behavior this is starting to happen—a debt default spiral could ensue that if left unchecked (i.e., without intervention by institutions like the ECB, EU or IMF) could throw Europe’s financial system and economy into a tailspin. Given the magnitudes of Italy’s debt and Italy’s and Europe’s economies, such an event would have serious consequences for the global financial system and world economy as well.

**Exhibit 3: Government Debt-to-GDP**

Country	2007	2010	2011
Japan	187.7	220.0	233.1
Greece	105.4	142.8	165.6
Italy	103.6	119.0	121.1
Ireland	24.9	94.9	109.3
Portugal	68.3	92.9	106.0
United States	62.3	94.4	100.0
France	64.2	82.4	86.9
Canada	66.5	84.0	84.1
Germany	65.0	84.0	82.6
United Kingdom	43.9	75.5	80.8
Spain	36.1	60.1	67.4

Sources: IMF staff estimates and projections  
 Note: Weighted averages based on 2009 purchasing power parity GDP.

**Exhibit 4: Changes in Government Debt-to-GDP**



Sources: IMF staff estimates and projections  
 Note: Weighted averages based on 2009 purchasing power parity GDP.

**Did Milestone EU Agreement Precipitate Italy’s Crisis?**

Ironically, the widely celebrated agreement recently hammered out for Greece (though not yet approved by the country’s new coalition government) may have led directly to the dislocation in Italian debt markets. In the agreement, EU policymakers convinced private Greek debt holders to accept a 50% “haircut” on the nominal value of their holdings. In order to avoid de-stabilizing the financial system, they also convinced holders to deem the haircut “voluntary” in order to avoid triggering various

types of protection against a Greek default. While the political motivation behind the proposed haircut is understandable, the effort to contain the crisis by not recognizing the haircut as a default has backfired—it may have conferred financial sector stability, but at the cost of undermining yet another eurozone government debt market.

There are at least two reasons for this. First, the threat of similar haircuts on other governments’ debt has created significant risk for fiduciaries (fiduciaries are people or entities with a legal responsibility to exercise a high degree of care for others’ financial well-being, such as pension or mutual-fund managers, trustees, etc.). In the wake of the EU’s October agreement, buying the debt of a troubled eurozone government at any price over fifty cents on the euro became much riskier from a fiduciary standpoint.

Second, the effectiveness of insurance and other hedging arrangements has been thrown into question. For example, the effectiveness of credit default swaps (CDS), a form of insurance used by major financial institutions to hedge against the risk of a bond issuer defaulting, has been severely undermined as the contracts did not provide the protection that buyers expected. To put this in every-day terms, imagine that after a major, multi-vehicle automobile accident, the government was able to exert enough pressure to get the parties involved to agree that the incident did not constitute an accident, leaving everyone involved without insurance coverage. The current and future value of automobile insurance would suddenly be thrown into question, and people would be forced to consider alternatives to driving. If market behavior is any indication, the alternative for government-debt investors was to suddenly avoid purchasing the debt of Italy and other troubled eurozone governments.

**Europe’s Non-Sovereign Sovereigns and the ECB**

Although the terms “government” and “sovereign” are sometimes used interchangeably when it comes to national government debt, sovereign can be something of a misnomer. A government is truly sovereign only when it is the monopoly issuer (usually via the country’s central bank) of the money that its interest-bearing debt is denominated in. A government that issues debt in another nation’s currency (also known as external debt) is not technically sovereign by that definition, and its range of choices for dealing with a debt burden is more limited as a result.

Although not an external currency in the traditional sense, the euro is an external currency for all intents and purposes when it comes to the fiscal affairs of EMU member nations (the EMU is the European Monetary Union, the bloc of countries that have adopted the euro as their national currency). Unlike countries such as Japan, the U.K., the U.S. and many others, eurozone

countries lack the direct ability to expand their domestic supply of money. This takes the option of central-bank intervention off the table (the upside is that this lowers the risk of policy-induced inflation). As a result, the less competitive nations of the eurozone face difficult and politically unpalatable choices regarding public goods and services (including pensions and social safety nets), public investments (such as infrastructure and education), domestic price levels, labor costs and regulations, and employment. In other words, fiscally challenged EMU nations are faced with painful austerity measures, state asset sales and the like because short of leaving the eurozone, those are the only choices possible under their current monetary arrangements. And with bond buyers threatening to strike—both Spain and Italy have experienced poor government debt auctions in recent days—the situation looks all the more difficult.

To help, the EU created the European Financial Stability Fund (EFSF) in the hope that it would be able to backstop troubled government debt. However, the Fund was capitalized by European national governments, whose ability to provide funding is finite, and many of whom are the troubled governments in need of the Fund's help—a fact reflected in the Fund's recent difficulty issuing new debt. There's also now a risk that the haircut on Greek debt could be imposed at some point on EFSF debt holders. France and Germany are having trouble agreeing on how large the Fund should be and how to get there. In the meantime, with each passing wave of the crisis, the intended size of the Fund becomes smaller relative to the amount of troubled debt in existence. The EFSF struggled with its most recent bond issues, and the spreads demanded by buyers over German debt have widened. Unless the ECB becomes involved as a funder of last resort, which is extremely unlikely given the membership distinctions between the EU and EMU (not all EU nations are members of the EMU, and the ECB is the central bank only for the latter), the EFSF looks incapable of stemming the tide.

The only entity that has the power to add to the net supply of euros is the supranational ECB, but it is unlikely to engage in activist policies for several reasons. First, doing so would put the interests of troubled governments ahead of fiscally solid ones. Second, buying national government debt remains controversial (it would be analogous to the Federal Reserve buying the debt of U.S. state governments, which under almost all circumstances would also be highly controversial). Finally, it is among the most conservative—if not the most conservative—of the world's central banks. Its charter severely limits its ability to pursue activist monetary policy, and the strong influence of France and Germany within the ECB reinforces its aversion to activism. France has long been a 'hard money' country, from the days when its central bank acquired massive gold reserves in the years leading up to the Great Depression through the 1960s and early 1970s, when Charles de Gaulle berated the U.S. for running large deficits, and redemptions of U.S. dollars for

the U.S. Treasury's gold reserves eventually forced President Nixon to close Treasury's 'gold window,' leading to the final collapse of the post-World War II gold standard in 1973. As for Germany, it is still heavily influenced by the country's painful experience with hyperinflation in the early 1920s, as a recent speech by German ECB council member Jens Weidmann demonstrates (emphasis added):

*One of the severest forms of monetary policy being roped in for fiscal purposes is monetary financing, in colloquial terms also known as the financing of public debt via the money printing press...[the prohibition of monetary financing in the euro area] is one of the most important achievements in central banking... specifically for Germany, it is also a key lesson from the experience of hyperinflation after World War I.*<sup>1</sup>

### Will Internal Devaluation Work?

Austerity measures are also referred to as internal devaluation, as they cause internal factors (including standards of living) to decline until the domestic economy is in equilibrium with its external environment, without any change to the exchange rate between the country's currency and other countries' currencies (lowering the value of the domestic currency is a form of external devaluation). Because exchange rates within the eurozone are fixed by definition (they all use the euro), austerity is the obvious textbook choice for pursuing fiscal balance and economic equilibrium within the eurozone.

However, the history of external debt crises (there are many examples) should give investors pause. Historically, in fiscally challenged countries with external debt and a fixed exchange rate, the internal devaluation approach, even when diligently and sincerely pursued, has often failed, sometimes spectacularly.

Of course, austerity measures don't always fail, and whether internal devaluation can succeed in Europe without eventually causing a severe financial meltdown or deep EMU-wide recession is still open to question. If those measures don't succeed, then the only institution capable of managing the fallout from Europe's government debt crisis will be the ECB. But to step into such a role, it will have to overcome significant legal and cultural hurdles, which may require that dire conditions unfold, such as a financial crisis capable of threatening the euro's existence, a deep recession

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<sup>1</sup> Jeff Black and Gabi Thesing, "Germany's Weidmann Says ECB Can't Bail Out Governments by Printing Money," *Bloomberg*, 11/8/2011, < <http://www.bloomberg.com/news/2011-11-08/germany-s-weidmann-says-ecb-can-t-bail-out-governments-by-printing-money.html>>, accessed 11/11/2011

spreading to all of the eurozone including Germany, or some similarly painful event.

## Our View

With Italy now in the market's sights, the risks to the global financial system and world economy have increased substantially. There is no easy fix for the eurozone's troubles, and there will continue to be many political impediments to a lasting resolution. The stakes and potential fallout are much greater now that Italy is on the firing line, and that means that volatility, uncertainty, and correlations within and between risky and safe-haven asset classes, are likely to remain elevated.

There is a significant risk that Europe is entering or already in recession. The European Commission just lowered its 2012 GDP growth estimate for Europe to 0.5% from 1.8%, and corporate bond spreads (the difference between the market yield on corporate debt and the market yield on safe-haven debt) in Europe continue to warn of a severe contraction next year. If a recession occurs, internal devaluations will be all the more difficult, and lower debt-to-GDP ratios all the more elusive. Financial institutions could fail and larger and stronger eurozone governments could wind up in the market's crosshairs along with Italy and others (notably, yields and spreads on Austrian, Belgian and French government debt have been rising of late). It's also unlikely that the rest of the world economy would emerge unscathed from a deepening European crisis or recession. Clearly, Italy is a game-changer.

On the bright side, recent market behavior has been somewhat reassuring. Certain measures of interbank lending in euros have dropped dramatically, and other measures of risk aversion between banks have eased or at least leveled off. This has been helped by unexpectedly rapid political developments in Italy (the outgoing prime minister having set the expectations bar rather low), and it may also indicate that the ECB (perhaps along with other central banks) is involving itself in the crisis. Both are promising developments, but it will take significantly more time, effort and resources to resolve the European debt crisis for good.

## Our Funds

Fund-by-fund exposures to Italy (both government and private sector issuers) are provided in the following table. Investors should be aware that a crisis involving Italy's debt would be likely to have global rather than just domestic or regional effects (an assumption supported by the historically high global co-movements within and between risky asset classes during the past year).

**Exhibit 5: Fund and Benchmark Exposures to Italy as of 10/31/2011**

Fund	Fund (%)	Benchmark	B'mark (%)	Difference (%)
SIIT Core Fixed Income	0.11	Barclays Capital US Aggregate	0.22	-0.11
SIIT Enhanced LIBOR Opportunities	0.04	BofA ML USD 3M LIBOR Constant Maturity	0.00	+0.04
SIIT High Yield Bond	0.36	BofA ML US High Yield Constrained	0.32	+0.04
SIIT International Equity	1.58	MSCI EAFE	2.73	-1.15
SIIT Large Cap Disciplined Equity	0.01	S&P 500	0.00	+0.01
SIIT Long Duration	0.52	Barclays Capital Long US Govt/Credit	0.55	-0.03
SIIT Multi-Asset Real Return	0.11	Barclays Capital 1-5 Year US TIPS	0.00	+0.11
SIIT Screened World Equity Ex-US	0.41	MSCI All Country World ex-US	1.60	-1.19
SIIT Ultra Short Duration	0.18	Barclays Capital Ultra Short US Treas 9-12M	0.00	+0.18
SIIT World Equity Ex-US	0.58	MSCI All Country World ex-US	1.60	-1.02
SIMT Core Fixed Income	0.03	Barclays Capital US Aggregate	0.22	-0.19
SIMT Global Managed Volatility	0.47	MSCI World Index	0.00	+0.47
SIMT High Yield Bond	0.30	B of A ML US High Yield Constrained	0.32	-0.02
SIMT U.S. Fixed Income	0.11	Barclays Capital US Aggregate	0.22	-0.11
SDIT Ultra Short Duration Bond	0.23	Barclays Capital Ultra Short US Treas 9-12M	0.00	+0.23

Source: BlackRock, SEI

Data is as of 10/31/2011. Figures are rounded to the nearest basis point (0.01%).

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