What rising yields mean for Italy

Special

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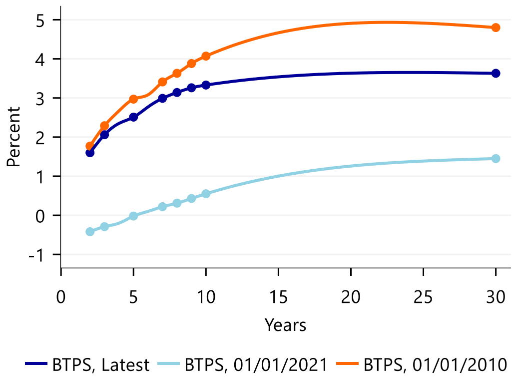
Summary

- Bond yields and spreads in the Eurozone have been on the ascend.
- Italy is particularly vulnerable given its enormous debt pile and track record of weak growth.
- Although the ECB has moved into 'spread-containment' mode, we are very sceptical about its ability to cap spreads, whilst in any case Italian yields are unlikely to come down.
- This means that the Italian government will have to deal with higher debt servicing costs on its massive debt load going forward.
- We argue that at this point in time, while clearly being a headwind for fiscal policy, the rise in yields still seems bearable in the short to medium run.
- In three to four years' time, however, debt affordability could become an issue, with the interest payments-to-revenue passing the 10% threshold, if current forward rates materialise.
- A jump in yields back to the June peak or even to sovereign debt crisis episodes, would rather substantially bring forward both affordability and sustainability challenges.
- One event possibly driving bond yields higher are 2023 elections or even snap-elections.

Entering a new chapter with rising interest costs…

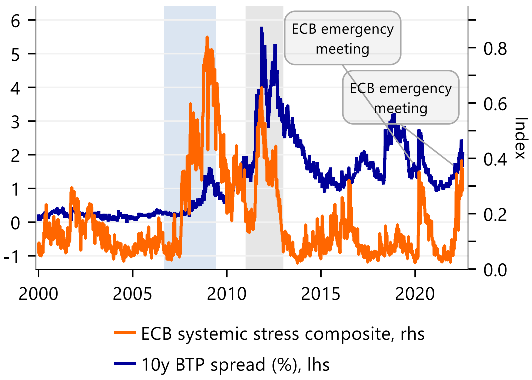
After some two years of relative calm, bond yields and spreads in the Eurozone have been on the ascend again. Rising inflation, a very soon-to-be-tightened monetary policy and a weak economic outlook are among the drivers behind higher market rates and uncertainty or risk premiums.

Figure 1: Italian sovereign yield curve – huge shift since mid-2021



Source: Macrobond

Figure 2: Systemic risk spurred ECB into action (or was it 'il spread'?)



Source: Macrobond

Whilst monetary tightening has an impact on bond yields across the Euro bloc, differences in debt metrics become more important again in the environment described above. **Given its enormous debt pile, its track record of sluggish growth and history of political instability, Italy is particularly vulnerable in times like these**. Hence, while yields on 10-year German bunds have increased by some 150 basis points since the start of 2022, those on Italian BTPs have risen by as much as 210 bp. Mid-June, Italian yields briefly touched their highest stance since 2014. Meanwhile, last time that the Bund-BTP spread reached those mid-June levels of around 240bp was May 2020 when the first Covid-19 pandemic wave was in full swing.

Although recent volatility has spurred the ECB into 'spread-containment' mode, we note that it's resolve may yet be tested by markets whilst any spread-control does not preclude ongoing yield pressures (see also here and here). And both can cause headaches. Rising spreads, for example, can hurt the transmission of monetary policy by the ECB and become self-fulling at some point, driving yields of peripheral countries ever higher. Higher yields, in turn, clearly make it more expensive for a government to finance its debt.

At the point where yields on new government debt are higher than on maturing debt, higher interest payments start eating into other expenditure and/or would lead to (faster) debt increases further down the line- since the government would need to increase its total borrowing to both fund increased interest payments and ongoing other existing expenditures.

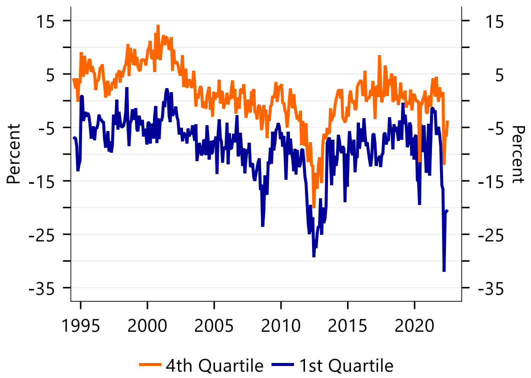
...but no revival of the debt crisis, yet

In this special we specifically focus on what the rise in yields means for the Italian government's interest costs, affordability and sustainability. We argue that at this point in time, while clearly being a headwind for fiscal policy, the rise in yields still seems bearable in the short to medium run. That is, in the absence of unwarranted risk premiums and under the assumption that the current European/Italian political status quo does not change abruptly.

In three to four years' time, however, debt affordability could become an issue. We will look into this in more detail below, but if current expected yield levels (14 July), as reflected in forward rates, materialise, Italy's interest payments as a percent of its government revenues, would exceed 10% by around 2026/'27. This is a threshold often used by the credit rating agencies to measure affordability. This is not to say that the increase doesn't matter now already. It obviously makes government spending more expensive and will likely lead to fiscal tightening or less spending on other expenditures than interest further down the road. Moreover, it also makes borrowing and hence investments for corporates more expensive, hurting economic growth.

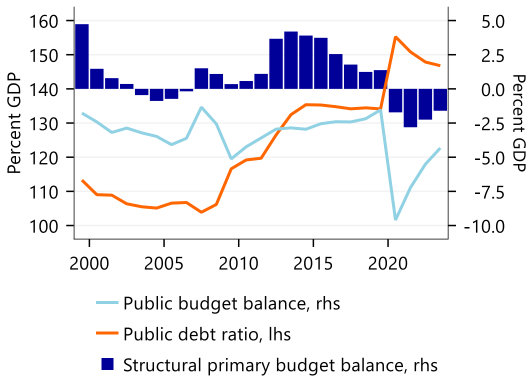
Lower growth is of course the purpose of tightening monetary policy, in order to get inflation back under control. The inconvenient truth, this time around, however, is that it will be more difficult to tame inflation by suppressing demand, given the supply-driven nature of inflation. It's the type of inflation that is generally of the unwanted kind: it raises prices but lowers output. Meanwhile, just like in many other member states, lower-income households are struggling with rising energy bills. Households in the lowest income quartile earlier this year were more negative about their expected financial situation than at any time in the past 20 years (see figure below).

Figure 3: Italy: Consumer confidence: financial situation over next 12 months – by income



Source: Macrobond

Figure 4: By some measure, Italy's debt metrics are worse now than in 2010



Source: Macrobond, DG ECFIN projections

Debt metrics, then and now

The very sharp rise in interest rates in less than one year has revived memories of the sovereign debt crisis. But today is not 2011. Although some parallels can be drawn, several things have changed, some for the better, others for the worse.

At face value, Italy's **debt-to-GDP** ratio is much higher now; its **yield curve** has been approaching the levels seen in the heady 2010s (Figure 1, although ultra long rates are still some 100bp below their levels back then). And its **structural primary balance** has been consistently below zero since the pandemic struck. This is worse than before the onset of the 2010-12 European sovereign debt crisis (Figure 4).

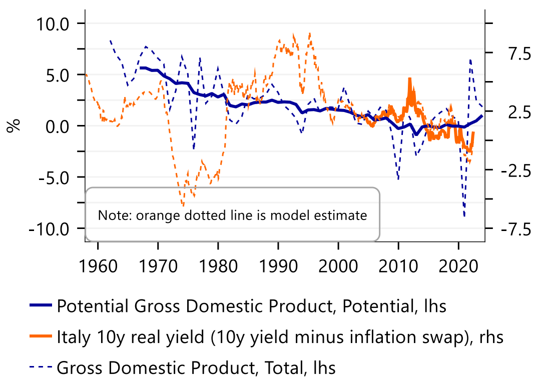
The well-known **(long-term) debt sustainability condition** implies that the government's primary surplus (i.e., the budget balance excluding interest payments) should be equal (or higher) than the outstanding public debt-to-GDP ratio times the difference between the effective real interest paid on existing debt and the real GDP growth rate. If not, the ratio of debt-to-GDP will explode. This, of course, is only a simplistic and long-term condition and it's not an early-warning indicator. But it is insightful nevertheless.

A quick glance at these parameters shows that – for now – Italy's GDP growth rate (or prospective growth rate, Figure 5) exceeds the inflation-adjusted yield on its bonds. Note, also, that the country's true interest costs will lag and are much smoother due to the maturity of its debt. Nevertheless, its lacklustre growth performance since 2000 (with barely any growth in GDP) highlights the case for containing real yields.

Recent reforms on the labour market and judiciary and considerable investments financed by loans and grants from the EU's 672.5bn RRF (of which Italy is receiving the considerable sum of EUR 191.5bn) hold out the prospect of a higher growth rate in the coming years, but the worsening cyclical backdrop due to the energy crisis could still spoil things. Moreover, the current type of inflation the country is experiencing is not the favourable kind: purely technically it leads to a lower debt-GDP ratio, if all else is kept unchanged. But the negative terms of trade shock that is behind that rise in inflation arguably takes the shine off that observation.

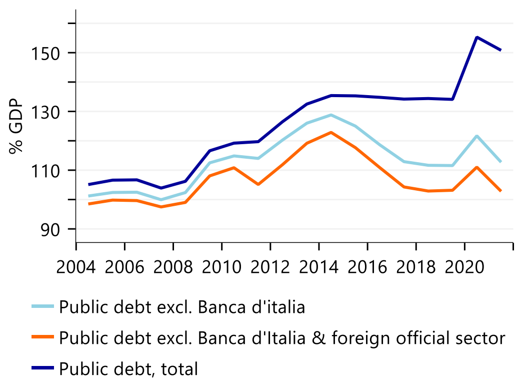
Another metric often used in debt sustainability analyses is **financing needs**. The IMF and European Commission, for example, generally foresee debt sustainability issues if financing needs are higher than 15% of GDP in the short run, and/ or exceed 20% in the longer run. Financing needs consist of refinancing maturing debt and the issuance of new debt to fund its primary deficit and interest payments. If we assume current debt is rolled over at maturity and the primary deficit gradually moves back to a small surplus in the second half of this decade, gross financing needs will consistently be close to or somewhat higher than 20% of GDP over the next ten years.

Figure 5: Italian 'real yield' still below real GDP growth



Source: RaboResearch, Bloomberg, Ameco

Figure 6: Gov. debt-to-GDP excluding debt held by the Eurosystem is lower than pre-debt crisis



Source: Macrobond, IMF, Eurostat, RaboResearch

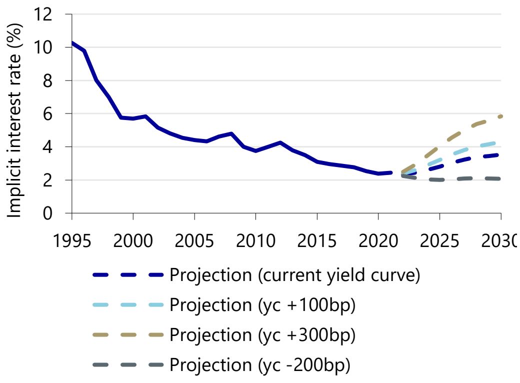
That said, there is also **a factor that alleviates concerns**. Although Italy's debt-to-GDP ratio has risen significantly since the Eurozone debt crisis, all of that increase -and even more- has 'ended up' on the Eurosystem's (ECB + Banca d'Italia) balance sheet. The interest payments made to Banca d'Italia will ultimately flow back to the Italian government[1]. Moreover, with the ECB likely to continue to reinvest its bond portfolio for years to come, that part of Italy's gross financing needs is pretty much guaranteed. As such, we can take this portfolio -approximately a quarter of total debt- out of the equation (Figure 6).[2] This means that financing needs to be fulfilled by private investors would drop to around the 15% threshold for the rest of this decade. This clearly alleviates, but not completely removes challenges ahead.

Projecting interest rate costs

We now zoom in on what the recent rise in yields implies for future interest costs for the Italian government. Since markets have been very volatile and the ECB is now facing a 'stagflationary' environment that clouds the interaction between its monetary policy instruments, we also look at a positive and a negative scenario.

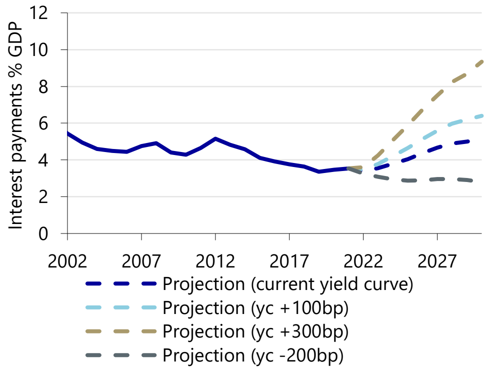
For our calculations we had to make several assumptions. An important assumption is that bonds will be re-issued at the same tenor when they redeem, with a new coupon equal to the future spot rate. Based on the forward rates, yields on new debt will on average be higher than those on maturing debt[3]. We combine this with a negative yet improving primary balance in the years until 2027, as projected by the IMF, and a positive balance thereafter -in line with the average between 2002 and 2019. **In such an environment, the implicit (average) yield on Italian government debt is projected to rise from 2.4% in 2021 to 3.5% in 2030 (Figure 7). Accordingly interest payments would increase from 3.5% of GDP in 2021 to 5.2% of GDP in 2030, requiring a larger primary surplus to keep the debt-to-GDP ratio in check.** To keep the debt-to-GDP ratio at its (projected) 2022 level, a primary balance of around -0.5% of GDP is required in the coming few years moving towards +1.5% in the final years of this decade. This compares to a primary balance of -3.7% last year and +1.3% on average between 2002 and 2019.

Figure 7: Implicit interest rate



Note: Current yield curve stems from 14 July
Source: Macrobond, Bloomberg, RaboResearch,

Figure 8: Interest payments as % of GDP



Note: Current yield curve stems from 14 July
Source: Macrobond, Bloomberg, RaboResearch

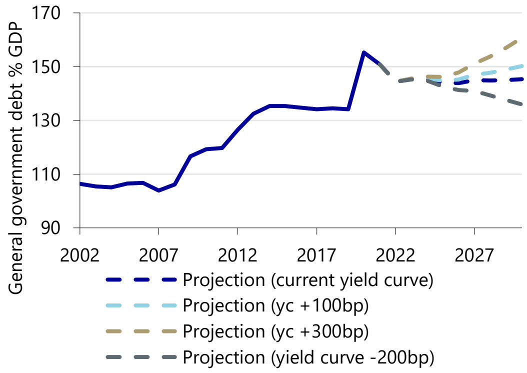
[1] Although this has never been explicitly said so, we assume that the risk-sharing agreement in the Eurosystem (with 80% of the risk of national bond purchases falling with the NCB) also implies 80% profit sharing. The remainder (20%) would be distributed in a pro-rata fashion. As such, the majority of interest revenues still flows back to Banca d'Italia.

[2] The ECB intends to continue reinvesting the maturing bonds purchased under its APP for "an extended period of time past the date when it starts raising the key ECB interest rates and, in any case, for as long as necessary to maintain ample liquidity conditions and an appropriate monetary policy stance", whilst it will reinvest maturing securities purchased under its PEPP until, at least, end-2024.

[3] We derived the total interest costs from the modelled BTP costs by using the current ratio of 70% for BTP debt over the total Italian debt (BTPs, other notes/instruments and loans).

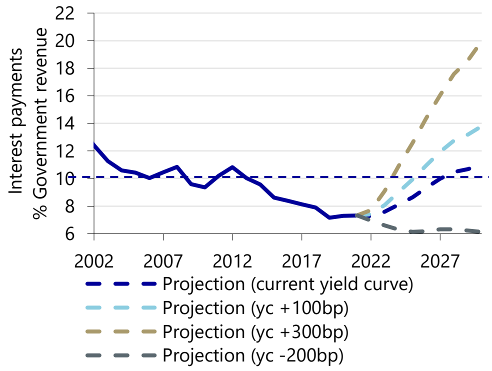
Another important metric to keep an eye on is **interest payments as a percentage of government revenues**. The higher that ratio, the lower debt affordability. Debt affordability can be described as *the extent to which current and future debt payment obligations can be met without introducing measures that substantially harm growth, welfare or quality of ongoing public services*. According to credit rating agencies, debt affordability becomes at risk if interest over revenue is higher than 10%. Figure 8 shows that that ratio was above -or very close to- the threshold in the two decades prior to 2015, after which it declined. Yet based on the assumptions above, while projecting revenue as a % of GDP at the average of between 2009 and 2019, its stands to rise again, reaching 10.0% in 2027.

Figure 9: Debt ratio



Note: Current yield curve stems from 14 July
Source: Macrobond, Bloomberg, RaboResearch

Figure 10: Interest payments as % of revenues



Note: Current yield curve stems from 14 July
Source: Macrobond, Bloomberg, RaboResearch

A sensitivity analysis: what if bond yields alter course

Given that the trajectories depend on multiple assumptions, we have run multiple sensitivity analysis. One of the most interesting is what happens with the above mentioned indicators if bond yields jump or fall substantially.

Figures 7-10 show what would happen to the implicit interest rate, interest payments as a % of revenue and GDP, and the debt-to-GDP trajectory, respectively if the yield curve would shift. We have drawn scenarios in which yields jump 100 basis points across the curve and hence move back to their June peak; jump 300bp to more or less mimic the average during the heat of the sovereign debt crisis; and fall 200bp to move back to the start of 2022. The impact of such higher yields would be substantial for all these indicators. For example, **the pain threshold for debt affordability would be hit already in 2024 or 2025, whilst financing needs -corrected for ECB repurchases- would pass the short-term unsustainability threshold by a wider margin**. In the most severe scenario, Italy would also fail to stay below the longer-term threshold by the end of this decade.

Finally, **a 100bp (300bp) jump in yields would push the required primary balance to stabilise the debt-to-GDP ratio from -0.5% to 0% (0.5%) in the short run and from 1.5% to 2.5% (4%) in the longer run**. It needs no explanation that this would pose an even larger challenge .

Other sensitivity analysis, including, for example, different paths of the primary balance, government revenues and GDP growth are available upon request.

Policy uncertainty could push yields higher

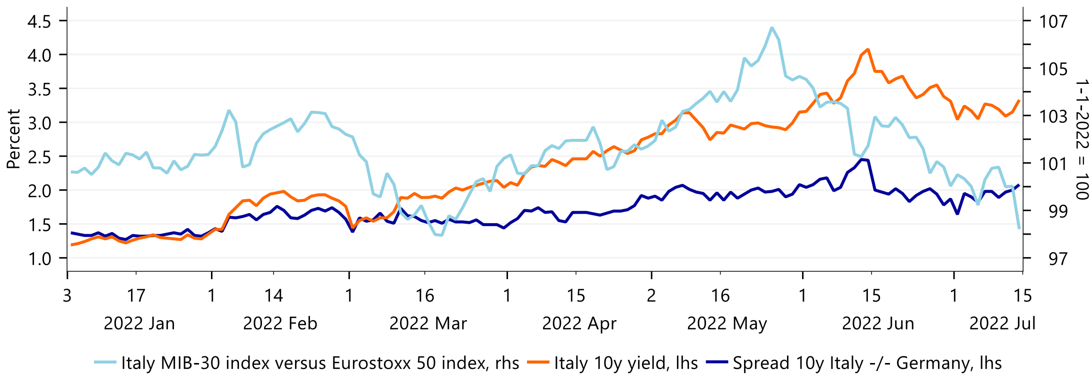
Apart from ECB policy and economic performance, **2023 elections or even snap-elections this year could be a driver of higher bond yields**. We have seen in the past that political uncertainty, perceived irresponsible fiscal policy, resulting clashes between the government and the European Commission, and distorted personal relationships can push Italian yields higher. For now, the fact that European budget rules do not apply and the warm relationship between Italian PM Draghi and other EU leaders, are keeping clashes between Italy and the rest of the block at bay.

Yet the upcoming elections could spark fear of clashes in the future. Polls suggest that the far-right Brothers of Italy would come out on top if elections would be held right now. Recent developments on the left and the worsening financial position of households only strengthen their chances of winning the elections, since they are the only opposition party. A Brothers' win need not result in a Brothers government per se, but let's assume that it does. While highly unlikely to call for an EU or euro-exit -especially in light of Recovery fund money- Brothers of Italy is more Eurosceptic than most other parties, and certainly more sceptic than the current Draghi government. In that sense, frictions between Italy and the EU/ Eurozone would likely increase under a Brothers' government. Especially, once the EU budget rules get back into play and the government would need to implement austerity measures. That said, the pile of Recovery money might persuade even Brother's to implement just enough reforms to receive hard-needed money from the fund. Just as it has led to Lega softening its tone.

In any case, **the road to elections is likely to be littred with hefty campaigning** and parties like M5S and Lega to soften their support for Draghi, to get protest voters back in their camp. In fact this process has already started this year with Lega's Salvini warning that he may decide on staying in the coalition during his annual party congress on 18 September. Similarly, absence of Draghi's other coalition partner, in a vote of confidence yesterday, is clear evidence that the race for the Italian voters is heating up.

In reaction to M5S snubbing the vote, Draghi has handed over his resignation to President Mattarella -even though he survived the confidence vote. He argued he could no longer implement the government agenda as intended. At the moment of writing, it is still unknown whether Draghi will adhere to Mattarella's request to speak to parliament, to see if he could still stay on as PM of a government of national unity or if snap elections will have to be called. Whatever happens in the coming hours and days, it is a given that political uncertainty is to increase over the coming months, possibly pushing yields higher. Yesterday's market closing and this morning's market opening give some indication that markets dislike political uncertainty in Italy, with spreads and 10-year yields up more than 20 bps since Wednesday.

Figure 11: Spreads and bond yields on the rise again; equities underperforming



Source: Macrobond, Bloomberg

Monetary policy framework, then and now

Since the advent of the sovereign debt crisis, the ECB has launched a slew of instruments to deal with sub-par inflation and/or fragmentation risks. Most of these instruments (and that includes, TLTROs, APP/PEPP, OMT) could potentially still be used in future crises. However, the economic circumstances have changed quite drastically since the pandemic -whilst OMT remains an unused politically loaded instrument government leaders are hesitant to request.

Pandemic support in Europe (in essence massive budgetary support financed to a large extent by the central bank) has proved relatively successful, but is now one of the reasons for severe mismatch problems in goods markets and the labor market (including tight labor markets in many member states). This has been aggravated by a huge global energy and food supply shock, which gathered momentum in 2021 and which took a turn for the worse with the war in the Ukraine.

This means that the ECB is now facing an entirely different economy in which demand-management becomes ineffective and, with persistently high inflation (as is probably already the case right now), even entirely inappropriate. But by turning towards a tightening of monetary policy through hiking policy rates, a process which began late 2022, the ECB is also contributing to fresh spread widening pressures. In so far as spreads are persistent or set to widen even further, the one-size monetary policy is likely to lead to more demand and economic growth destruction in Italy than Germany, for example. In this regard, ECB President Lagarde, in her speech on 6 June, noted that the *"ECB must preserve the transmission of monetary policy to the entire Eurozone, and must therefore ensure that there is no fragmentation preventing this"*. She added: "*We have existing instruments, we have described them in the past. PEPP reinvestments, with total flexibility if warranted across time, jurisdiction. And if it is necessary, as we have amply demonstrated in the past, we will deploy either existing -and adjusted- instruments, or new ones.*"

Transmission Protection Mechanism faces real challenges

With the Council under strong pressure to deliver rate hikes (the weakness of the euro is one factor there), this only underscores that a strong anti-fragmentation tool is needed to ensure an orderly hiking cycle, while such an instrument may not have been necessary without any hikes. We believe the new anti-fragmentation tool, currently dubbed the 'Transmission Protection Mechanism' (TPM) will come with relatively light conditionality and without a predetermined purchase cap, even though this requires some convincing of the hawks. To avoid interference with the inflation mandate, we expect liquidity draining operations to offset any purchases.

However, making it credible and making it work is far from a given, as the Council will have to balance the TPM's ability to preserve the transmission of monetary policy evenly across the Eurozone with political palatability and risks of moral hazard, while also avoiding that the instrument impedes on the overall policy stance and inflation mandate. This creates a real risk that the TPM's design will disappoint, either because the tool is too limited in scope, or because of the perception that it may never be used.

In other words, you can twist the ECB's instruments or even turn them upside down, but the bottom line is that all its instruments remain 'demand' oriented and unable to cope with what essentially is a supply shock. Moreover, our Rates colleagues think that, certainly in its first iteration, it is very unlikely that the new TPM will be able to cap EGB spreads and yields, suggesting that the Italian government will have to deal with higher debt servicing costs on its massive debt load going forward.

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A summary of the methodology can be found on our website