The role of the european central bank, spanish and italian bond market in the pan...

Finance

The paper " Strong Demand for Spanish, Italian Debt by Emese Bartha" is an excellent example of an article on finance and accounting. An article was published in the Wall Street Journal by Emese Bartha on January 12th, this year, which discusses the debt situation of Spain and Italy. Euro has been the center of global financial attention since last year and this year, predictions are that the bond market of Spain and Italy will play a very crucial role in the whole European debt crisis. The European Central bank also has a key role in this situation. Experts are calling it a ‘ backdoor bailout’; European Central bank lent half a trillion euros to local and regional banks. As a result, the Spanish Treasury has been able to raise 10 billion euros from auctioning three bonds. The yields have dropped by about 1% as Spain doubles its target of 5 billion euros. Italy is also looking very good after its 1st bond auction of 2012 where it paid less than half of what it had paid last year. While reading the article, any person with the basic financial knowledge can’t help questioning that why is it all sitting so well that ECB is injecting money into financially troubled areas when supplying more money will destroy the currency? Michael Leister, strategist at DZ Bank in Frankfurt said that it is feeling good only because markets are very ‘ complacent’ at the moment (Tracy, 2012). As a result of this rescue by ECB, the risk premiums of both the Italian and Spanish bonds have narrowed. By Wednesday’s close, Spanish risk premium dropped to 339 points from over 354 basis points. A similar case is with the Italian bond, which has dropped below 500 basis points.

This risk premium or yield spread stands at 2. 735% for Italy on 12-month bills, which is a considerable drop from 6% only one month ago in the Dec

2011 auction. But the important question is, for how long will the banks keep supporting medium and longer-term government debts. It looks as if it is only a temporal solution and it will not end the European debt crisis. One probable strategy, at least for Spain would be cut its net debt issuance by around 25%. As the article reveals how much money Spain has risen, it will be a great challenge to achieve that mark, but comparing debt situation of Italy and Spain, the latter looks in a better and safer credit position.

The article talks about financial plans in the bond sector of Italy and Spain, and how the overall bond market will move for this year in European Markets but the risk of default still seems to be prevalent. The Italian bond system looks like it’s been hedged by the central bank. Whenever the ten-year yield crosses over 7%, the central bank moves in and purchases those debts. This debt seems as if revolving in a circle and not actually decreasing. How can the debt problem be solved by buying more debt?

It is also mentioned in the article that ECB is still looking forward to offering 3-year cash in February while on the other hand experts are showing concerns over Hungary’s plans for a precautionary aid package with IMF and the European Union. When Hungary unexpectedly sold over 44billion forints bonds (3, 6 and 10-year bonds) it has averaged 9. 41% yield. Individually analyzing the bond yields don’t look so bad but selling the debt in contrast to its original plan demands serious attention from financial experts.

Overall, Italy needs to be making more desperate debt reduction decisions based on long term goals. At this moment, Italy’s public debt amounts to 120% of its GDP. The target for Italy is around 440 billion euros for this year. Italian government needs to look at other options besides relying on ECB alone. Spain is in a difficult debt situation too but comparatively in much better debt situation than Italy. Whenever investors pay European governments to buy their money, the financial situation is awful.