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Italy Default Fears Grow As Borrowing Costs Rise

By Bonnie Kavoussi

Market confidence in Italy's ability to pay its bills faded quickly on Wednesday, and experts warn that fears of Italian default could weigh heavily on the U.S. economy as it fights against a renewed economic downturn.

Interest rates on 10-year Italian bonds rose above 7 percent on Wednesday to a euro-era high, increasing by almost a full percentage point from Tuesday's rates. While the European Central Bank may yet step in to buy Italy's debt, allowing the nation to keep making payments on its current debt load, some economists say that it is becoming increasingly likely for Italy to default, dragging Europe and the United States into recession anew.

Italian Prime Minister Silvio Berlusconi, who has failed to fulfill his promises to European leaders to slash his government's massive debt, vowed Tuesday to step down once the Italian parliament has passed austerity measures. But that did not stop investors from demanding higher interest rates from Italy on Wednesday as fears mounted that an Italian default could freeze lending and send banks falling like dominoes.

"This is exponentially more serious than Lehman Brothers," said **Bernard Baumohl, chief global economist at the Economic Outlook Group**. "The exposure of the global banking system is much greater, and there is really a lack of any solution to this."

Nariman Behravesh, chief economist at the economic forecasting firm IHS Global Insight, estimated a 15- to 20-percent chance that Italy will default on its debt, which he said would cause bank runs, a credit crunch and a year-plus-long recession in Europe, leading to a recession in the United States that would send unemployment over 10 percent, he said.

Investors around the world panicked in response to the spike in Italian interest rates. The S&P 500 plummeted 3.67 percent, the DAX in Germany fell 2.21 percent and the value of the euro plunged 2 percent against the dollar. Bank stocks also took a beating, as shares for Goldman Sachs fell 8.21 percent, JPMorgan

Chase stocks fell 7.08 percent and Morgan Stanley shares plunged 9.01 percent.

Economists say borrowing costs are a leading factor in Italy's possible default. Beyond the nation's staggering debt and its own economic contraction, Behravesh attributed the spike in those costs to political dysfunction in Europe. Italy will become much more likely to default, he said, if the interest rate on its debt rises above 8 percent.

The wider European bank failure likely sparked by an Italian default would likely cause other troubled countries in the euro zone -- such as Spain, Portugal and Greece -- to miss their debt payments, some economists say, as the other nations' higher borrowing costs make their debt burdens likewise unsustainable. Before long, the whole of Europe could be plunged into recession.

And that plunge would make wider waves. At 27 percent of the global economy, the European Union is the world's largest player, according to IHS Global Insight, and economists fear a deep recession in Europe would drag the rest of the world down, too.

Baumohl said that if Italy defaults on its debt, the United States would fall back into recession because exports to Europe would slow, banks would be forced to take losses on their European loans and debt insurance, and U.S. banks would tighten lending.

Behravesh said he expects the European Central Bank to come to the rescue. The ECB most likely will print more money to buy Italian bonds, he said, to allow Italy to keep financing its debt, and European leaders will probably boost the size of the European Financial Stability Facility, the euro bailout fund, to an amount that can at least calm markets.

"The ECB now is the only thing standing between Europe and the precipice, so in the end the Germans will come around," Behravesh said.

Borrowing costs for Italy would fall if the country implements the necessary budget cuts and structural reforms to allow its economy to grow and make its debt burden more sustainable, said Sung Won Sohn, an economist at California State University.

But Italy seems increasingly unable to address the crisis on its own. Since the country's liberal opposition party is "very beholden to unions" and the nation is entering a recession, it would be difficult for the government to implement the structural economic reforms and budget cuts necessary to reassure investors and lower interest rates, Behravesh said. Moreover, as the Italian economy shrinks, budget cuts are likely to worsen the economy and debt burden as taxpayers' incomes fall, he said.

An Italian default would endanger French banks the most, since they have invested $106.8 billion in Italian sovereign debt, according to the Bank for International Settlements. U.S. banks have invested $12.9 billion in Italian

sovereign debt, which they would lose if Italy defaults.

Some economists say that it is also unlikely for Italy to abandon the euro, since the value of the Italian lira would plummet in the international markets. The rush to move Italian money elsewhere would crater the nation's banks people, rendering the move counterproductive, said New York University economist Nicholas Economides.

Stronger European economies might leave the euro if Italy defaults, however, a scenario that some economists see as more threatening. If banks holding European sovereign debt fail absent needed capital, the broader European economy would shrink sharply, endangering the stability of the euro zone as a whole, the economists warn.

Behravesh said he expects European leaders to strive to avoid a scenario in which Italy leaves the euro, which would likely precipitate a series of similar departures. After borrowing costs spike for other countries, he said, the temptation for them to devalue their own currencies to have cheaper exports and a cheaper sovereign debt burden would be irresistible.

"If Italy leaves, it's all over for the European experiment, as far as I'm concerned," Behravesh said.

Reuters reported on Wednesday that German and French leaders have discussed creating a smaller euro zone made up of stronger economies.

Behravesh said that while he can't imagine that European leaders have seriously discussed removing Italy from the euro zone, such "really irresponsible" political discussions are contributing to higher interest rates for Italy.

"That's not even playing with fire," he said. "It's playing with dynamite."