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'Monti Effect' Fizzles Before $574 Billion New Year: Euro Credit
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(For more on Europe's debt crisis, click EXT4.)

By Chiara Vasarri and Lorenzo Totaro

Dec. 23 (Bloomberg) -- Prime Minister Mario Monti's market honeymoon is ending as Italian bond yields near 7 percent signal mounting concern his government may struggle to sell 440 billion euros ($574 billion) of debt next year.

Monti took just five weeks in office to push through a 30 billion-euro emergency budget package aimed at taming surging borrowing costs. Investors reacted to the plan's final approval by the Senate yesterday by driving up the yield on Italy's 10- year benchmark bond by 12 basis points to 6.91 percent, near the
7 percent level that prompted Greece, Ireland and Portugal to seek bailouts. It was at 6.94 percent at 10:13 a.m. in Rome.

"The Monti effect has now also been priced in and I think there is a lot of room for disappointment next year," said Lex Van Dam, who manages $500 million in assets at Hampstead Capital LLC in London.

Italy's 10-year bond yield reached a euro-era record 7.48 percent on Nov. 9, one week before Monti took over from former Premier Silvio Berlusconi and three months after the European Central Bank started backstopping the nation's bonds. The yield fell to as low as 6.26 percent on Dec. 6 as investors rewarded Monti, a former European Union commissioner, before giving back those gains the following week with EU policy makers struggling to stamp out the debt crisis.

"To overcome the sovereign debt crisis, it's vital that everybody look at our debt with confidence," Monti told upper- house lawmakers yesterday. "It is essential that Italians buy government bonds and treasury bills, whose yields are very high.
We must trust ourselves."

Next Week

The Rome-based Treasury will sell 9 billion euros of 179- day bills and as much as 2.5 billion euros of zero 2013 bonds on Dec. 28. The next day Italy will auction four different bonds, including a 10-year security.

Italy, the euro area's third-largest economy and second most-indebted after Greece, may hold the key to the single currency's survival. It must repay about 53 billion euros in the first quarter from the region's total maturing debt of 157 billion euros, according to Swiss lender UBS AG. The nation, with 1.9 trillion euros in debt, owes a further 3.2 billion euros in interest payments based on the average five-year yield of the past three months.

"Paradoxically, the only real lever that Monti has is the weakness of Italian government debt," said Nicola Marinelli, who oversees $153 million at Glendevon King Asset Management in London. "The more yields go up and the specter of a failed auction becomes real, the more he can push for leeway from the parties" that support the government in Parliament.

Structural Reforms

Monti reiterated yesterday that he will turn his attention next to overhauling Italy's rigid labor market and streamlining the welfare system.

"The structural reforms are regarded by the market as more important than the budget measures," said Stephen Lewis, chief economist at Monument Securities Ltd. in London. "Because these structural reforms impinge on special interest groups, Monti will face strong opposition, possibly on the streets, but definitely from politicians representing those interests."

Monti's plan, which includes a pension overhaul and tax increases including on primary residences, may also push Italy deeper into a recession that the government forecasts will begin in the current quarter.

The economy shrank 0.2 percent in the third quarter from the previous three months, when it grew 0.3 percent, national statistics institute Istat said this week. The government forecasts a shrinking economy in the fourth quarter, 0.6 percent growth in 2011 and a 0.4 percent contraction next year.

Guaranteeing Bonds

The budget plan, Italy's third round of austerity since June, also introduced rules to allow banks to use bonds guaranteed by Italy as collateral to obtain loans from the European Central Bank. Banks including UniCredit SpA and Intesa Sanpaolo SpA issued about 40 billion euros in state-backed bonds this week, two people with knowledge of the matter said.

"I think the fact that Italy is now more or less guaranteeing the banking system means that the ratings agencies will come down even harder on its sovereign debt ratings," said Van Dam, the fund manager.

Standard & Poor's on Dec. 5 placed 15 euro nations on review for a possible downgrade, including the euro-area's six AAA rated nations, amid the worsening debt crisis. Italy's was downgraded by the main ratings companies this fall starting in September when S&P cut it one level to A, citing weak economic- growth prospects.

'Recessionary' Measures

Monti's package, which seeks to help balance the budget in 2013, will cut 0.5 percent from gross domestic product over the next two years while reducing public debt, Bank of Italy Governor Ignazio Visco told Parliament on Dec. 9. Some of the drag on growth may be offset if borrowing costs fall, he said.

"It's a recessionary budget package, which won't produce further proceeds for the state and will choke growth, generating the need for a further budget adjustment," Gianvittore Vaccari, a senator of the opposition Northern League, said yesterday.

The plan's approval came one day after the International Monetary Fund ended a visit to Rome as part of its monitoring program. The IMF said the team will return next month.

"The IMF-led technical mission in early January could pose a degree of risk, as there is the potential for misinterpretation of its presence," said Thomas Costerg, an economist at Standard Chartered Bank in London. "The bottom line is that Italy is simply too big to fail and too big to be bailed out, and the ECB has no other option but to be more flexible on sovereign debt."

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