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Bond exodus on a par with eurozone bank run

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By Richard Milne

A great deal of attention is being heaped on the possibility of a bank run across the eurozone. But something just as important is currently happening: a bond run.

Foreign investors have left the government and corporate bond markets of Italy and Spain in droves in the past year and there is little evidence of the selling slowing down. If anything, the worry would be that the process carries on for some time as it has done in Greece, Ireland and Portugal.

There is little doubt that a generalised bank run across several countries would be disastrous. But so far there is scant evidence of it. Deposits at Italian banks have increased in recent months while those at Spanish banks have only dropped slightly.

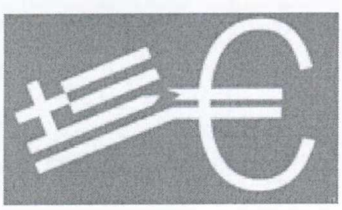
But it is a different story when looking at foreign capital. JPMorgan analysts estimate €200bn of Italian government bonds and €80bn of Spanish bonds have been sold by foreign investors in the past nine months, more than 10 per cent of each market.

Matt King, a credit strategist at Citi, has gone further, peering into the detail of the infamous Target2 balances, which track cross-border payments in the eurozone. Much attention has focused on how Germany's Target2 surplus has been increasing rapidly while peripheral eurozone countries' deficits have soared.

Mr King takes balance of payment data from each country, which shows all cross-border capital flows, and subtracts Target2 and other public sector flows to show how much foreign capital flight there has been. The results are pretty frightening.

FT series

If Greece goes ...



Spain has seen €100bn of outflows, about 10 per cent of GDP, since the middle of last year. Italy has been even worse affected – the latest figures show €230bn has flown out of the country in the same period, close to 15 per cent of output.

Much of the selling has been done under the cover of the European Central Bank's cheap-loans programme for banks, known as longer-term refinancing operations. **Foreign**

- Greece is back on a knife edge. In a timely and far-reaching series, the FT looks at the potential consequences of it leaving the eurozone

investors have used the thirst from domestic bondholders for local paper to get out.

Mr King estimates more is to come. Looking at the three bailed-out countries, Greece, Portugal and Ireland, he argues that capital flight is very hard to stop. Foreign bank deposits have fallen almost continuously in the past one to three years in all three countries, dropping 52 per cent on average from the peak. Foreign bond holdings have sunk by a third. "We estimate a further €200bn in flight from each of Spain and Italy is quite likely without further policy action," he added in a report this week.

All this matters because Italy and Spain still represent big chunks of bond indices tracked by many investors. Indeed, because Italy has the third-largest bond market in the world it has accounted for more than 20 per cent of some government bond indices. Once risk managers spot that degree of concentration in an asset that is souring, more and more sell orders are likely.

And there are still plenty of assets to sell. JPMorgan estimates that, in Italy and Spain, foreign investors hold €800bn in government bonds, €500bn in corporate bonds and €300bn in shares. Throw in a collective €3tn of bank deposits, from everyone not just foreigners, and the potential for more pain in Italy and Spain is immense. Of course, selling by foreign investors may not matter for the countries if domestic investors can take up the slack. Japan offers the ultimate example of a country not reliant on foreigners to finance its sizeable deficit. But the speed of the selling matters – a trickle could be absorbed by domestic buying but the sort of outflows that Spain and Italy have seen recently are hard to cover if they carry on. Instead, as the Target2 balances show, the official sector has been taking the strain.

The euro project was meant to be different. It was designed to encourage cross-border capital and investment flows, not lead to nationalisation. The increasing worry is that – aside from a few countries such as Germany – eurozone markets are becoming ghettoised, dominated by domestic investors who no longer invest as much outside their borders.

All this is without discussing the likelihood of a Greek exit from the euro or further default. One or the other seems increasingly likely from the markets' point of view.

Contagion is hard to gauge but further selling from foreign investors at the least seems all but certain. More insidiously, a Greek default or exit, by crystallising losses for governments and central banks throughout the eurozone, could call into question their commitment to stand behind other troubled countries. Italian and Spanish borrowing costs – now at premiums to Germany's that are close to euro-era record levels – could spiral higher if investors worry about whether there is a backstop behind them.

A bank run may get the big headlines. But the run of foreign capital is potentially just as scary for the euro's future.