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Getting to Eurobonds by reforming the ESM

The following guest post on the European Stability Mechanism and Eurobonds is from Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator. The views expressed here are his personal opinions and do not necessarily reflect the views of Consob.

The European Stability Mechanism was established in late 2012 as a permanent bailout fund for the euro area. It was born as a compromise during a crisis and its powers were deliberately limited by the desire of creditor countries to segregate risks within the periphery.

I have drafted a radical reform proposal that would transform the ESM into a real stability provider for the euro area as a whole. It would become a transition mechanism to a unique federal debt for the euro area.

This could be achieved through a risk-weighted cash contribution system that should increase the financial soundness of the Mechanism in terms of balance sheet structure. In return for the insurance premiums received, the ESM should guarantee the public debts of all member countries, allowing the progressive transition to a single federal debt of the euro area.

These capital injections would give the ESM the opportunity to fund worthwhile investments in stressed countries while supporting the realignment of the economic cycles within the single currency. Instead of an emergency lender to support the financial economy, the ESM would become an ongoing support mechanism to the *real* economy by boosting productivity in poorer parts of Europe.

This transition scheme would help develop a deep and liquid market for Eurobonds, which could better compete with US treasuries in attracting international investors. Unlike alternatives such as European Safe Bonds, which reject the concept of risk-sharing, my proposal foresees only a temporary segmentation between shared and un-shared.

Once the transition is complete, the entire public debt of the euro area would be under the joint liability of all member countries — the debate about risk weights for government debt within the euro area would become obsolete.

If we really want to prevent the single currency from disintegrating under the pressure of nationalist interests, we must adopt a genuinely federalist perspective. The euro area must graduate from a set of States that shares a currency into a common project.

The ESM today is too constrained by its rules:

1. Lending is only available in deeply distressed scenarios
2. The first three shareholders (Germany, France and Italy) can veto any decision even under the emergency procedure
3. Recipient countries must agree to “structural reforms” to access emergency loans
4. The capital structure is flawed

The ESM has subscribed capital of €704bn but only 11.4 per cent of that has been paid-in; the remainder is callable shares. Thus, the Mechanism runs a large gap between subscribed capital and paid-in capital. Should the Board of Governors call in authorized unpaid capital (€625bn), ESM members would have to quickly meet the call with additional contributions.

This contingent-equity scheme exposes the Mechanism to the insolvency risk of individual countries at the moment of greatest need. If Italy needed funds, Spain might find itself unable to raise its committed capital quickly enough, which could cause the crisis to spread. This explains why the maximum amount of financial support that the ESM is allowed to grant is €500bn — €200bn *lower* than the subscribed capital.

In addition to its callable capital, the ESM can raise funds by issuing investment-grade bonds and other liabilities. According to the latest Annual Report, the Mechanism has issued debt securities for a total of €85.6bn, an amount comparable to the paid-in capital.

With this moderate leverage, the ESM was able to provide financial assistance to Greece and Cyprus, conditioned upon the implementation of strict domestic reforms. The Mechanism was also involved in the indirect recapitalization of Spanish banks in 2012.

Overall, the ESM disbursed no more than €87bn; but in the event of a disruption in a major economy such as Italy or Spain, the Mechanism could face a liquidity squeeze, if not even the veto from its “hawkish” members. Germany, for instance, wants to transform the ESM into the fiscal supervisor of the public accounts of national governments. Emergency loans would only be given after debt was restructured and strict conditionality imposed from outside. ESM support for a large country such as Italy in the event of a sovereign debt crisis would be far from obvious.

As long as it is conceived in this logic, the ESM does not really contribute to increasing the resilience of the single currency. Rather, it is only a burden, especially for those countries – such as Italy – which would be called to make significant financial contributions at the time they were committed to fiscal consolidation programs, and which remain exposed to the risk of an ESM’s failure to intervene in case of need.

Put it differently: in return for its contribution to the ESM's capital (€21.7bn cash), Germany controls the decisions of the Mechanism through to the veto right. Italy also holds a veto right because it has already paid €14.3bn and has a potential liability for another €111bn, but this is basically useless and is no guarantee of help in an extreme scenario.

More generally, the current ESM conformation misinterprets the meaning of "stability". The ESM can only give financial support in the last resort, but has no preventative or counter-cyclical role. This is because the euro-bureaucracy operates under the misguided belief that the causes of problems are to be found exclusively in the fiscal laxity of "rogue" countries, rather than the incompleteness and architectural distortions of the Monetary Union itself.

The Transition Mechanism: risk-sharing and strongest capital structure

I propose a risk-sharing agreement whereby riskier countries pay insurance premiums to the ESM in the form of capital injections. In exchange, these countries receive protection against their own sovereign risk from safer countries.

The new set-up should be enacted gradually: maturing debt securities should be re-issued with new risk-sharing clauses that provide for the joint liability of all euro area members. After ten years, all public debts would be fully risk-shared. Italian, French, or German sovereign bonds would cease to exist, having been replaced by unique euro area debt instruments with a single yield curve (and no credit spread), which represents the undiversifiable risk of the euro area as whole.

Insurance premiums would reduce liquidity risk because of how much they would increase paid-in capital. The Stability Mechanism would replace a contingent equity of €625bn with a certain liquidity injection 6-to-8 times lower.

The additional financial burden would be concentrated on risky countries. Those deemed safe by the markets, such as Germany and the Netherlands, would be exempted from any additional contributions — except in a crisis. Today Germany has a contingent liability to the ESM which is worth €168.3bn, but as net protection sellers, they would not have to pay any premiums.

One might argue Germany should receive the premiums directly, but this argument ignores the risk-sharing premises of the reform. Making the ESM the guarantor is logical because of the need of a *super partes arbiter* to give credibility to the risk-sharing agreement. For the same reason, the ESM's governance should be modified to remove the veto rights retained by Germany, France, and Italy.

The table below shows the expected impact of the proposed reform on the interest expenditure for selected Eurozone countries (net of the cost of the guarantee on debt):

Country	year 1	year 2	year 3	year 4	year 5	year 6	year 7	year 8	year 9	year 10	Total
Germany	1.8	3.2	4.2	5	5.7	6.3	6.9	7.4	7.9	8.3	**56.8**
France	1	1.7	2.1	2.3	2.3	2.1	1.9	1.5	1	0.4	**16.3**
Italy	0.5	-0.1	-1.6	-4	-7.2	-10.8	-14.7	-18.8	-23.1	-27.7	**-107.4**
Spain	-0.4	-1.1	-2.1	-3.5	-5	-6.7	-8.5	-10.4	-12.4	-14.5	**-64.4**
Netherlands	0	-0.2	-0.5	-1	-1.5	-2.1	-2.7	-3.3	-4	-4.7	**-20**
Belgium	0.2	0.3	0.3	0.4	0.3	0.3	0.3	0.2	0.2	0.1	**2.7**
Austria	0.3	0.5	0.7	0.8	1	1.1	1.2	1.3	1.3	1.4	**9.6**
Portugal	0.2	0.3	0.3	0.2	0.1	0	-0.1	-0.3	-0.4	-0.6	**-0.2**
Finland	0.1	0.2	0.3	0.4	0.4	0.5	0.5	0.5	0.5	0.5	**3.9**
Ireland	0.1	0.1	0.1	0.1	0	-0.1	-0.1	-0.2	-0.2	-0.3	**-0.5**

Germany would have the largest increase in its interest burden (about €5.7bn per year), followed by France (€1.6bn per year). Conversely, Italy and Spain would have the most interest savings (€10.7 and €6.5bn per year respectively). Risk-sharing implies redistribution from the centre to the periphery of the euro area. It's exactly the opposite of the risk-*segregation* that allowed Germany to save up to €240bn on interest expenditure from 2007 to 2016.

Compared to the European Central Bank's Asset Purchase Programme, this has the advantage of being irreversible. At the end of the 10th year all debt will be fully risk-shared. Should any individual country default selectively on the debt that has been guaranteed by its neighbours, it would of course be left alone with its angry creditors.

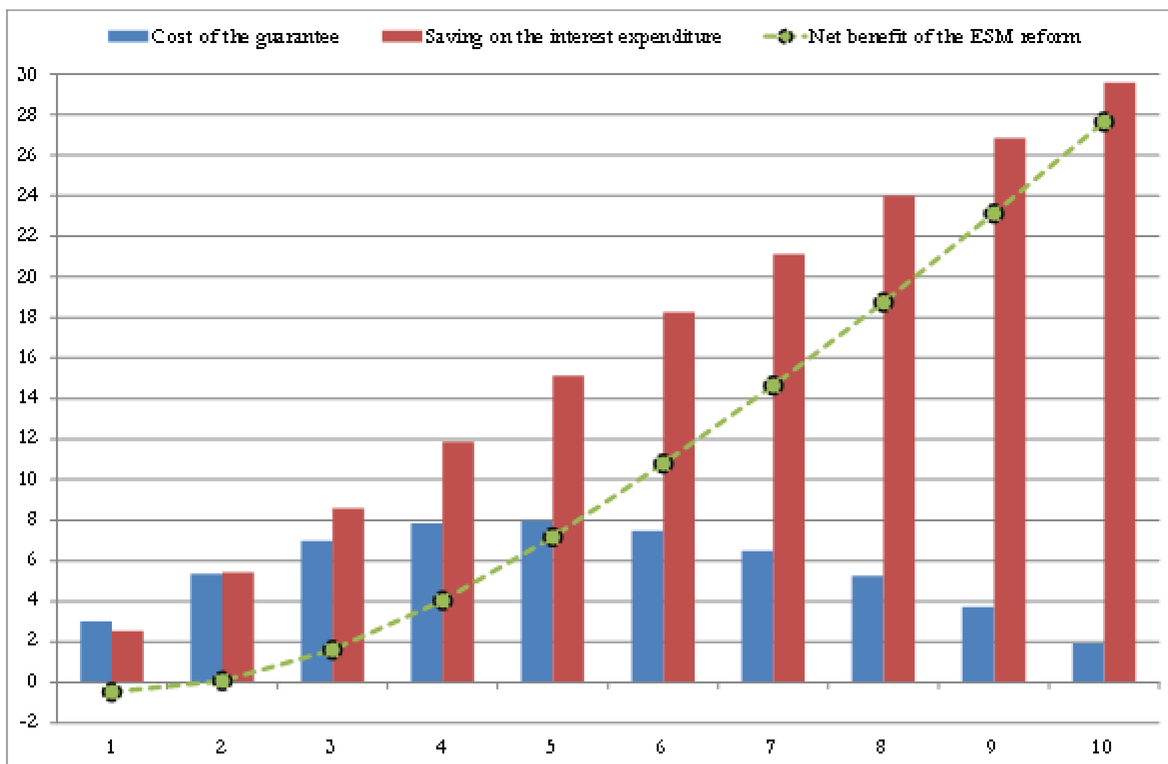
This should be enough to rule out moral hazard and give markets a clear message that euro area countries are genuinely committed to the integration project. That in turn would fuel a self-fulfilling convergence dynamic across sovereign yields.

If an investor believes sovereign spreads will disappear, he will buy a relatively cheap Italian BTP and sell a relatively expensive German Bund, cashing in on the difference. These convergence trades would reduce the insurance premiums that countries such as Italy would need to pay, with consequent savings in terms of public expenditure.

At first, the cost of the guarantee would increase as the share of public debt with risk sharing clauses goes up. Eventually, however, this trend should reverse as sovereign yields converge.

Figure 1 illustrates the expected effects of the proposal in the case of Italy, displaying the cost of the guarantee, the savings on interest expenditure with regard to the "no-change" scenario, and the combined effect of the two components:

Costs and benefits of the ESM reform: the Italian case (€ bn)



For Italy, the total cost of the guarantee would be €56bn to be spread over a 10-year horizon, but – as shown in the Figure – starting from the third year this cost would be more than offset by the savings in interest expenditure.

Core countries would also benefit from risk-sharing because the euro area as a whole would become more stable. The cost of the ESM guarantee would encourage fiscal responsibility: if additional borrowing is dangerous, it will lead to higher credit spreads and larger premiums to be paid in to the Mechanism.

Core countries would also be protected by prohibitions against redenomination of debt into other currencies. Such a ban would be unduly punitive in today's world, where risks are segregated along national borders within the euro area. But eliminating the ability to redenominate debt would be reasonable with genuine risk-sharing: if I'm interested in Germany sharing my risks, I have to deserve its confidence and give up the option of exiting from the euro to deflate my debt.

Using ESM leverage to boost investments and growth

Differences in the cost of money have created profound competitive gaps that have favoured some countries at the expense of others. In the past ten years, low interest rates have boosted output within core countries while the periphery was hit by funding difficulties and stringent European budgetary constraints.

The new ESM could help fix this. Today, the Mechanism has leverage of around 1 if we compare paid-in capital with bonds issued to provide emergency financing in Cyprus,

Greece, etc. My idea is to take advantage of the increase in paid-in capital (from the insurance premiums) to support the real economy of peripheral countries.

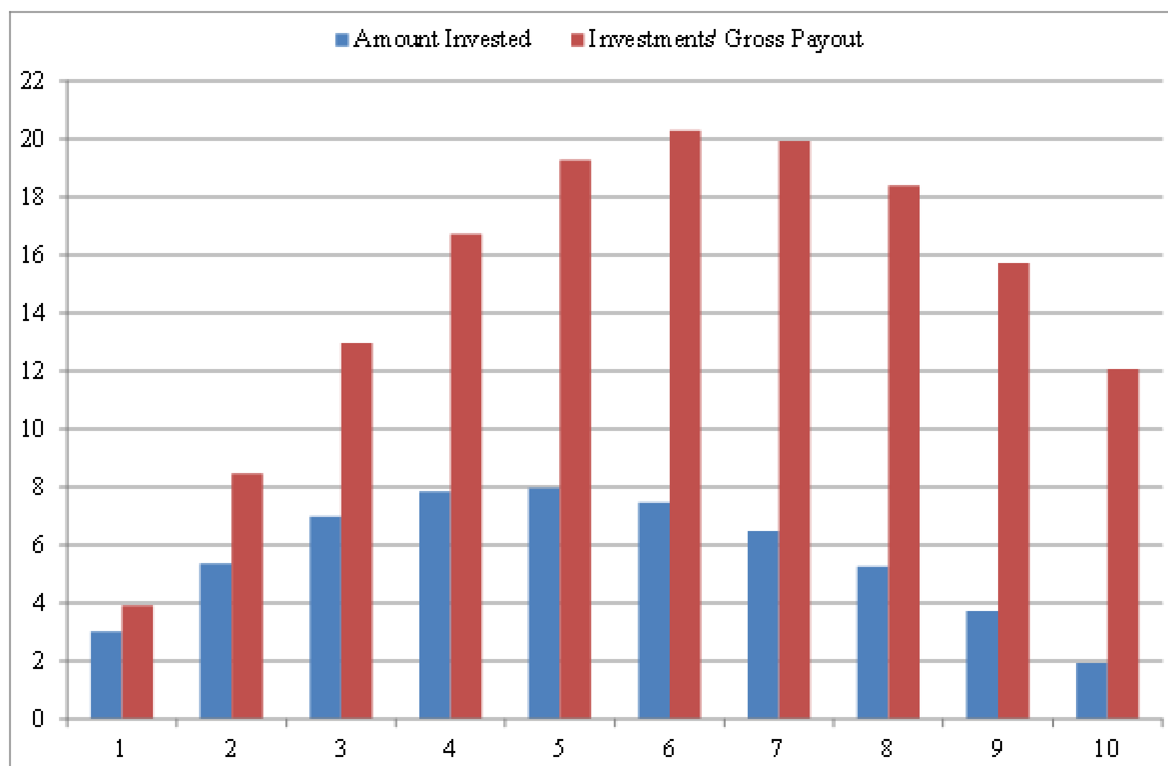
Net contributors to the ESM's capital, such as Italy, Portugal, and Spain, would benefit from additional investments that boost productive capacity. That in turn should help reduce their public debt/GDP ratios. Meanwhile, the ESM's balance sheet would have access to income-generating assets, for example through project financing solutions.

To ensure support from core countries, project selection and monitoring should be centralised in a European Investment Committee, either creating a spin-off from the EIB or drawing on existing institutions such as the European Fiscal Board.

This must be clear: governments of beneficiary countries will *not* be entitled to select projects and verify their progress; rather suitable EU supra-national institutions will be competent for this. As with the risk-sharing on public debts, even the investments funded by ESM will be European targets.

Figure 2 shows how Italy, which would be the largest contributor to the Stability Mechanism under the reformed risk-weighted contribution scheme, would nevertheless benefit from increased public investments:

Payout from ESM financing of public investments: the Italian case (€ bn)



Over ten years, Italy would pay an estimated €56bn to the ESM in the form of insurance premiums. The associated public investments would increase Italy's GDP by a cumulative €150bn.

The extra payments to the ESM would be a challenge, but they would be a big improvement to the current situation, where, because of the fiscal compact, the danger of rate hikes and the over-prudential discipline on non-performing loans, finance has stopped flowing to the real economy and the public budget has lost €100bn of tax revenues from banks and businesses.

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