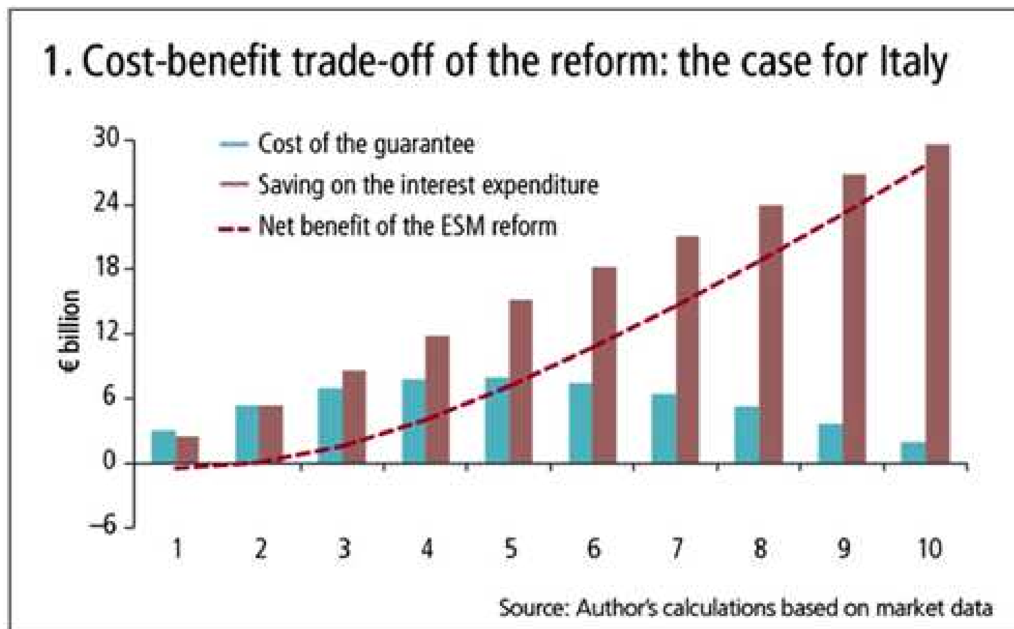
An Italian Regulator's Risk-Sharing Plan to "Cure the Eurozone"

by **Mike Mish Shedlock**



Marcello Minenna, a division head at the Italian securities regulator, emailed his plan to "Cure the Eurozone".

Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator, pinged me recently with his plan to save the Eurozone.

The plan requires debt guarantees with a catch: The catch is the guarantees have a price: The riskiest countries have to pony up the most for debt insurance.

His thoughts are in a downloadable PDF on Curing the Eurozone. A slightly different version can also be found on FT Alphaville: Getting to Eurobonds by reforming the ESM.

Minenna notes the "European Stability Mechanism (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."

Minenna proposes a risk-sharing agreement whereby riskier countries pay insurance premiums to the ESM in the form of capital injections.

Cost Benefit Italian Case

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

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.

At the end of the 10th year all debt will be fully risk-shared.

"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," claims Minenna.

Debt Mutualization

> **In exchange for the protection received, the most risky countries – such as Italy – would be called to pay annual cash contributions to the ESM for an amount equal to the market price of the guarantee**
>
> Marcello Minenna, London Graduate School of Mathematical Finance

Leverage

In his email, Minenna proposed "*ESM leverage capability* could be used to give a financial backing to public investments within peripheral Eurozone areas, in order to benefit of large fiscal multipliers usually exhibited by less developed regions."

Issues

1. The Maastricht Treaty which led to the creation of the Euro, does not allow such schemes. Germany has resisted all such schemes.
2. Germany and some of its neighbours would experience a deterioration of their creditworthiness because of the joint responsibility on the shared debt of the other states.

3. Minenna likely underestimates the amount of insurance required, perhaps by a lot, if debt debt volatility picks up.
4. Minenna likely underestimates the amount of debt once such a scheme is hatched.
5. Why might debt and volatility increase? Precisely because of the leverage Minenna espouses. Italy benefits only if debt or interest on debt does not soar.
6. Minenna's solution does not fix any key fundamental problems. One interest rate policy cannot serve 19 masters. There are huge productivity differences between various Eurozone countries.
7. Target2 is fatally flawed by design. No amount of insurance can possibly solve the fundamental point that Italy will never be able to pay creditors, primarily Germany.

Target2 Analysis

On November 6, I reported Italy Target2 Imbalance Hits Record €432.5 Billion as Dwindling Trust in Banks Plunges.

The latest numbers show Germany is owed €848.4 billion, primarily by Italy and Spain.

I struggle to see how these amounts can ever be paid back, insurance or not. If insurance is price correctly, Italy cannot afford it.

Debt Mutualization Key Points

Here are two essential points that Minenna never states explicitly.

- What cannot be paid back, won't be paid back.
- One way or another Germany will pay substantially.

Minenna's insurance scheme kicks the can still more, perhaps buying more time for some German politician to come into office who realizes the mathematical certainty of the above bullet points.

If Germany were to agree to an insurance scheme, we have the beginnings of debt mutualization in which debtors start defaulting on payments owed, for which insurance will never fully cover.

There are two and only two ways this ends.

1. Germany agrees to restructure the amounts it is owed.

2. Some country, likely Itlay, says to hell with it all, leaves the Eurozone, and starts a cascade of defaults.

If Germany were to accept Minenna's proposal, that would be a step in the direction of point number 1.

The political problem is Germany does not accept my two previous bullet points as a matter of fact.

Until Germany accepts it cannot be paid back and until a German chancellor is willing to take the heat for admitting the truth, the can-kicking insurance scheme cannot gain any traction.

As long as Germany believes it can and will be paid back in full by creditors, it is unlikely to accept any insurance schemes, debt mutualization schemes, or eurobonds.

Politically, Germany may not be willing to accept such schemes (even if it does accept my points), until it is well understood that some country is about to default.

Insurance Icing

I freely admit that Minenna seeks a solution that makes a eurozone superstate possible, whereas the Libertarian in me hopes the thing blows sky high.

Nonetheless, I honestly appraised his proposal. I think his proposal is well thought out, in general.

However, Minenna needs to explain how anything substantial can happen without a treaty change that every Eurozone country has to approve.

Even if such a thing could happen, how long would it take?

This is not a matter of me wanting one thing and him another. This is about political realities regarding German acceptance of what a genuine solution entails as well as political realities and timelines that suggest it cannot realistically happen given that it takes 100% agreement among 19 nations to do nearly anything at all.

This is yet another fundamental Eurozone flaw. Meanwhile, the political and economic clocks keep ticking.

Mike "Mish" Shedlock

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No doubts that my proposal on ESM reform based on risk-sharing is challenging…But the challenge comes mainly from the political arena …
This both bad and good… Bad because after years of risks segregation within the Eurozone we are all more and more used to German-thinking….Good because a political change will change our minds.
Reaching an agreement at the political level can change premia required by markets by dramatically changing their expectations … does anyone remember 17 years ago when the full commitment of participating governments to the Euro projects pushed investors to bet on the Germanization of sovereign yields? Then, massive convergence trades took place where market participants sold expensive Bunds and bought cheap Italian Govies

making profits from convergence. And what about the effect of the Draghi announcement of the OMT?
It’s a matter of expectations…and if you think about the fact that Germany has to pay (one way or the other), may be it could be worth also for Germany to reach an agreement.
What I’m proposing is less penalizing for core Eurozone countries than Euro-bond free debt mutualization proposals discussed in late 2011. I'm saying that Italy has to pay to share its risks (Eurobonds do NOT provide for these payments) and the net benefit comes from yields convergence and large fiscal multipliers of public investments.
As soon as the new ESM will start, the portion of public debt expiring each year will be re-issued with risk-sharing clauses providing for a re-distribution of risks across Eurozone governments; at most risk perception could worsen on outstanding (non-refinanced) Govies as they are not assisted by such clauses. But, with proper provisions, also this can be managed: these are hold-to-maturity bonds, whose depreciation wouldn’t affect the interest expenditure for the Italian Treasuries provided that selective default is forbidden.
With regard to risk-shared Govies my estimates of the amount of insurance required assume yields convergence. That’s true. After all, an agreement across Eurozone partners in the direction of a debt mutualization CAN DO this. And in the long term also EU treaties should be revised in a similar perspective, for instance allowing the ECB partial deficit monetization.
Let’s not fool ourselves. Either risks are shared or the EU Monetary Union is destined to disintegrate because it will remain the last viable option for Southern countries of the south (pushed by a Germany that is now in danger of being trapped in its own orthodoxy).
What I propose instead is an agreement that provides for a temporary application of the subsidiarity principles provided by the EU treaties: Germany will have to accept a normalization of its credit standing (PLEASE DON’T TELL ME THAT GERMAN NEGATIVE RATES ARE NORMAL!) to guarantee a viable future for itself and for the other Eurozone countries. In exchange for this, along with insurance-based contribution paid by risky countries, risk sharing clauses will have to prohibit the possibility of converting government bonds into a new national currency, thus making the option of exiting from the euro worthless.
What Mish says is true ... we are 19 different countries ... but sharing risks is the first step to truly re-align our diversities. It was exporting risk with vendor financing and then with deleveraging that Germany managed to increase its productivity ... and forced peripheral countries like Italy to devalue the work to try to recover land in an area where there are no plus the adjustments made possible by exchange rate movements ... it’s time for Germany to recover some of the risk it has exported ... Personally, I am tired of the pro-German mainstream, according to which the evils of the periphery are due exclusively to fiscal indiscipline . Let's stop segregating the risks and let's see ... and if the Italian economy re-starts (really) it will be able to repay the Target 2 deficit ... I say: LET'S GIVE US A CHANCE.