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Sharing Risks To Counter Germany's Plans Seeing Target2 Collateralization With Gold Reserves

by Tyler Durden

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

Despite being quite *soft* (there will *not* be *permanent transfers* between Member States), the recent proposals of the European Commission to deepen integration in the economic and monetary union could meet the opposition of Germany as soon as it will come out from the impasse on the creation of the new government. Germany could rather pretend a systematic application of *burden sharing* provisions in the event of a sovereign debt crisis.

Berlin wants private investors to take part in any losses on Govies and calls for an automatic 3-year debt reprofiling and (should it be not enough) for a restructuring to be approved by easy-to-achieve majorities and implemented according to the technical procedures decided by the Euro-bureaucracy. Appropriate Creditor Participation Clauses should govern these mechanisms and also prevent Govies' conversion in a new national currency in the case of exit from the euro.

What Germany calls *burden sharing* is not sharing at all, but a method for legalizing a wider risks segregation within individual countries, just it has happened since the Merkel-Sarkozy meeting in Deauville of late 2010. No coincidence that recently primary German newspapers spoke again of the Weidmann's proposal to impose a mandatory collateralization of any increase of Target 2 deficits of Club Med countries.

Favorite collateral: GOLD RESERVES of national central banks.

Once exhausted eligible collateral, a debtor country would not be more allowed to further increase its Target 2 liability and money held by its residents would be worth less than in other Eurozone countries. In front of the implicit devaluation of their cash holdings, people would accelerate the capital flight already ongoing (http://www.zerohedge.com/news/2017-09-24/ecbs-target2-lies-exposing-real-capital-flight-italy-spain) to be countered with capital controls which would bring to light the shadow currencies now embedded in sovereign spreads and to a SILENT DISSOLUTION OF THE EURO AREA.

German representatives don't hesitate to make extreme proposals to get hedged against risks of the periphery. In a speech given in late November at the BIS, Mr. Weidmann perfectly summarized the German feeling about periphery: the wrong with Southern Europe countries is their attitude for "*overfishing*", namely for excessive spending. And the lingering bond purchases of the ECB are equally wrong as they prevent interest rate levels "*to be aligned more strongly again with the risks in government budgets*".

TRANSLATION: GERMANY CLAIMS THAT SOVEREIGN SPREADS ARE TOO LOW. LET'S DO SOMETHING TO LET THEM RAISE AGAIN.

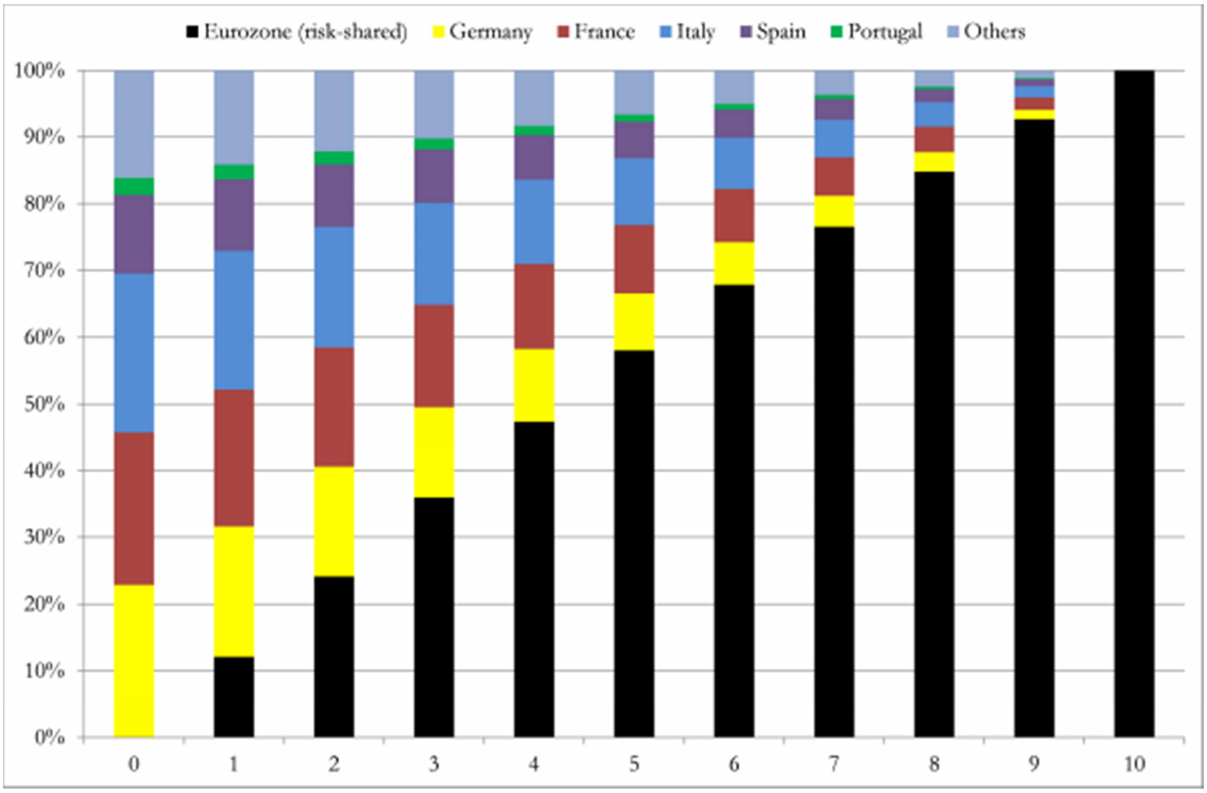
Sounds crazy, doesn't it? It's like wishing a remake of the roller coasters we lived in 2011-2012.

Why, then, is periphery so shy, and why doesn't it recall that the success of the European project requires risk sharing across members? We share the same currency, but absurdly this currency does not have the same price across Eurozone countries. We still have sovereign yield spreads (albeit mitigated by the ECB's QE – which, however, will not last forever) causing huge distortions at the economic and financial level for both the public and private sectors.

My ESM reform proposal moves from these considerations. Today the Eurozone bailout fund lends money to a distressed country who agrees to return it at maturity. This could be modified by switching to an insurance-based scheme where the ESM becomes the guarantor of the public debts of all countries: risky members – such as Italy, Spain or Portugal – pay (cash) marked-to-market premiums to the ESM capital and, in exchange, share their sovereign risk with safe members – such as Germany or France.

Specific risk sharing clauses could be embedded in the Govies to be refinanced each year providing for the joint liability of all Eurozone members. Within a decade the public debt of the Euro bloc would be fully mutualized and all States would have the same yield curve and, thus, the same cost of money, just as it should be within a common currency area.

<u>Transition from public debts of individual countries to a unique Eurozone risk-shared debt</u>



Indeed, if markets believe that soon public debts would be risk shared, investors will search profits by going long cheap high-yield Govies and short expensive low-yield Govies, speeding up the convergence process. In turn, such a process would allow risky countries to pay lower and lower premiums on Govies, thus gradually zeroing yield spreads across Euro sovereigns.

At most – should initially markets not believe in the strength of this new policy address – risk perception could worsen on outstanding (non-refinanced) Govies as they are not assisted by risk-sharing clauses and potentially subject to the risk of selective default. Even this issue (however temporary as over time all the debt would be risk-shared) should not have problematic impacts: for the governments (mainly indebted to fixed rate) the interest expense on outstanding Govies would not change, while for the investors these securities would become bonds to hold until maturity in order to avert capital losses.

I expect that initially the costs of the ESM's guarantee would increase over time as a larger portion of debt would enclose risk sharing clauses. But, then the effect of the convergence across yields would start prevail. For instance, in the case of Italy, starting from the 3rd year the savings in interest expenditure would outweigh costs, leading to a significant net benefit (more than €100 billion at a cumulative level).

Clearly, a complete reversal of markets' expectations is crucial for the success of the proposed reform. And, of course, politics matters … 17 years ago, the full commitment of governments participating in the Euro project pushed investors to bet on the Germanization of yields. Massive convergence trades took place where market participants sold expensive Bunds and bought cheap Italian BTPs getting positive windfalls from convergence. Again, convergence trades immediately came up in middle 2012 as soon as Draghi announced his "*whatever it takes*".

Today, there is a widespread consensus that Germany will have to pay (one way or the other). Well. This means that it could be worth also for Germany to reach an agreement. My proposal to share risks on public debts could prove to be less penalizing for core Eurozone countries than free debt mutualization proposals (so-called *Eurobonds*) discussed in late 2011. At least, under the reformed ESM set-up, Italy and other peripherals would have to pay to share their risks (Eurobonds do NOT provide for these payments) and the net benefit would come from yields convergence and large fiscal multipliers of public investments.

LET'S NOT FOOL OURSELVES! … Either risks are shared or the Eurozone will disintegrate as it will remain the last viable option for Southern countries (forced by German orthodoxy).

What I propose instead is an agreement that provides for a temporary application of the subsidiarity principles written in 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 future to itself and the other Eurozone countries….What it can reasonably pretend is that – like in a credit derivative – periphery pays the market price of the redistribution of risks produced by risk sharing and gives up the wild card of deflating its debt by leaving the euro area.

The following table shows the expected impact of the proposed reform in terms of variation in the interest expenditure for selected Eurozone countries (net of the cash contributions of risky countries to the ESM capital). Data are in euro billions.

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 and France would face higher interest payments, while Italy and Spain would get significant benefits. It is consistent with the predictable redistributive impact of financial resources from the center to the periphery because of risk sharing. Namely the opposite direction of the funds flowed to Germany and its neighbors over the last years due to risk segregating measures.

In front of the initial enlargement of their risk exposure, core countries would rely on a more resilient currency bloc and on the strong commitment of the periphery in favor of responsible fiscal conducts. In fact, moral hazard on fiscal matters would be discouraged by market penalties in the form of higher insurance premiums to be paid to the Stability Mechanism and of slowing down – if not even stopping – the convergence of sovereign yields.

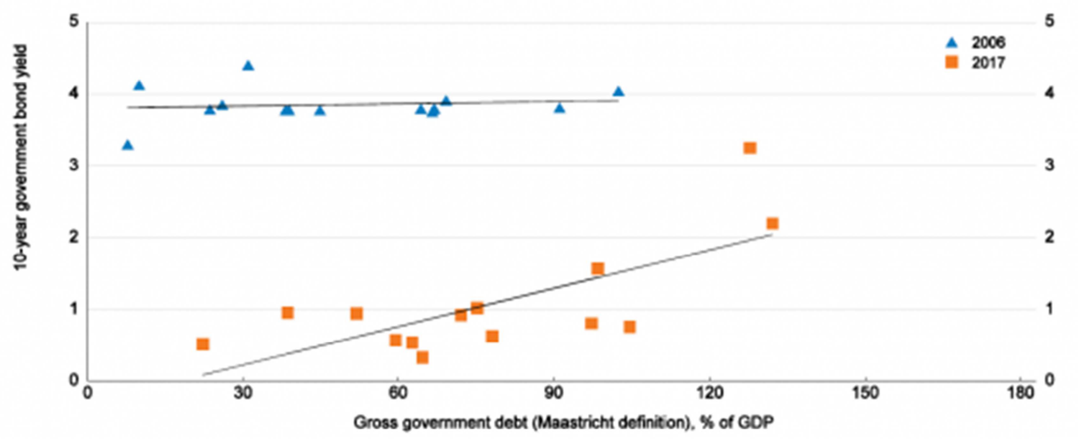
The proposed reform would also address some current weakness of the Stability Mechanism. Now the 89% of the ESM subscribed capital is represented by callable shares (€625bn), while paid in capital is well below the maximum firepower (just €80bn against €500bn of maximum amount disbursable to grant financial support to beneficiary members). Conversely, under the new set-up, the Mechanism could rely on the cash contributions paid by risky countries up to a total amount of €80-100bn. It would mean more than doubling the most solid financial backing available to the ESM. At the same time, the new contribution duties would be exclusively borne by risky countries (as they are the effective net protection buyers within the risk sharing agreement), while safe countries – as Germany and France – would be free of any additional charge.

One might argue that Germany would be entitled to receive these contributions, but such argument would not take into account the need of a *super partes arbiter*, such as the ESM, to give credibility to the risk-sharing commitment. For similar reasons also the emergence voting procedure should be revised according to a more democratic perspective by removing the veto right currently retained by Germany, France and Italy and lowering the majority needed to agree on a support program.

Of course, such revisions would leave northern countries more exposed to the default risk of peripherals, but it should be clarified that the ultimate aim of the reform is to share risks in order to significantly increase the distance to default of *all* members of the Euro bloc and make the ESM an authentic stability guarantor.

Chart below from the latest OECD Economic Outlook highlights how nowadays the link between long-term yields on Govies and debt-to-GDP ratio is much stronger than prior the crisis when risk sharing was assumed by financial markets …

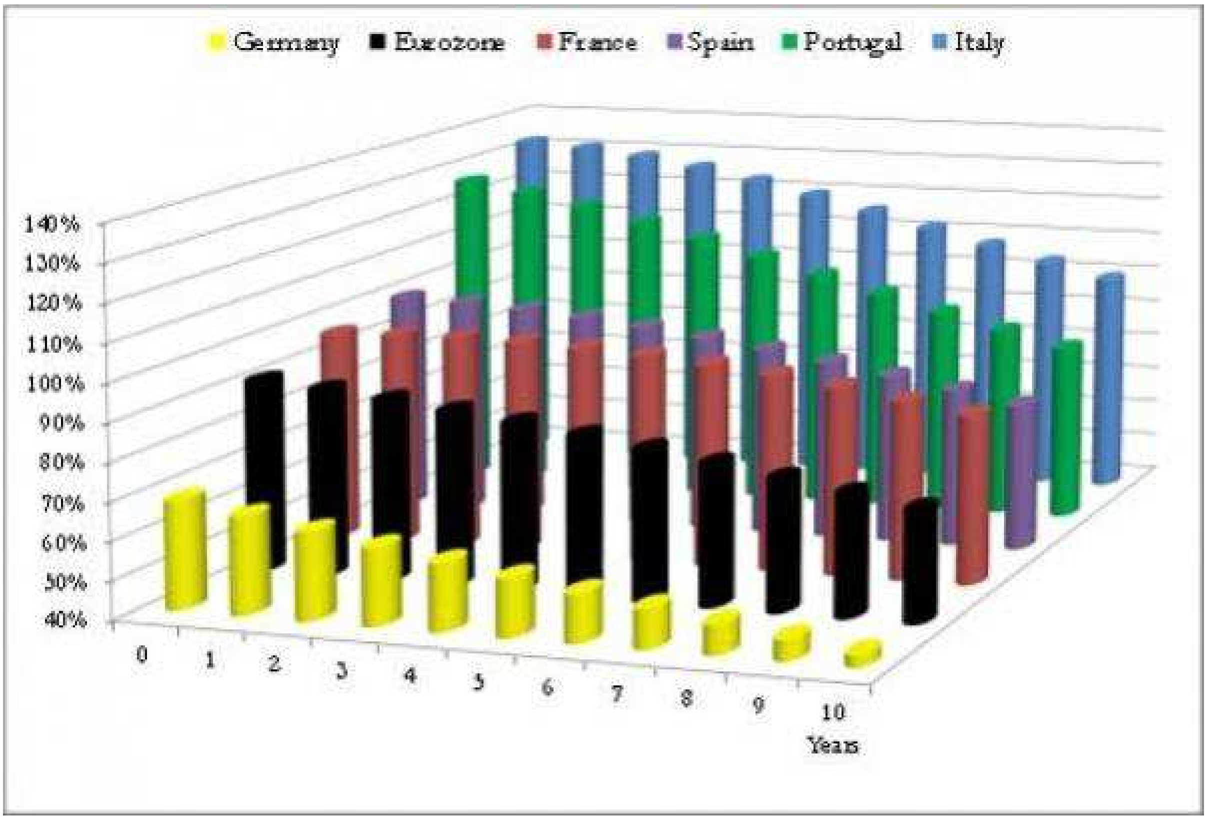
Figure 24. Long-term bond yields in the euro area better reflect differences in government debt than prior to the crisis



Note: Only OECD euro area member countries, excluding Greece. Government bond yields are annual averages. 2017 numbers refer to the OECD projections.

…supporting the expectation that the shift to *true* risk-sharing would deliver a generalized reduction of the debt-to-GDP ratios, a consequent improvement of the debt sustainability for any State and yields convergence. Even most indebted countries such as Italy and Portugal would fall below 100% at the end of the 10th year, while the ratio for the aggregated Eurozone would approach the Maastricht threshold of 60%.

Evolution of the Debt-to-GDP ratio for selected Eurozone countries



The last pillar of the ESM reform should focus on boosting public investments within weakest Eurozone economies in order to comply with the principle of shared growth and development stated by EU treaties. To this aim my proposal foresees a synergistic link between the new Stability Mechanism and the Fiscal Compact. The two inter-governmental agreements are already related to each other as access to ESM assistance programs is conditioned upon the participation within the Fiscal Compact. While preserving this feature, the revised set-up could favor investment opportunities by excluding from the structural balance (i.e. the budgetary balance net of cyclical components and one-off items, which is relevant for the Fiscal Compact) a maximum amount of public expenditure devoted to finance profitable projects backed by the ESM.

Indeed, the ESM could use its leverage capability to raise the funds needed to realize investments located in the Eurozone periphery. Currently the Mechanism operates with a unitary leverage to grant its assistance programs to deeply distressed members; but, under the new mandate, the liquidity raised by the ESM could be re-addressed to productive investments in order to provide more fragile countries with stronger antibodies to immunize from new shocks and reposition themselves on a durable path of growth. Economics are plenty of empirical evidence about the high fiscal multipliers of public investments, especially those located in less developed areas.

Leverage also provides a useful reference to objectively quantify the maximum admissible investment expenditure to be excluded from the structural balance: it must correspond to the cash contributions to the ESM capital charged to risky countries as insurance premiums on their risk-shared debt. Indeed, such a cap would proportionate new liquidity raised with leverage instruments to the updated capital basis of the Mechanism, keeping unchanged its overall leverage ratio and riskiness. A similar provision would also make the new set-up more appealing for peripheral countries required to disburse extra payments to the bailout fund, while core countries' concerns about the risk of wastes and mis-investments could be addressed by assigning the selection and monitoring of projects to a European committee, such as the European Fiscal Board which to date fulfills a purely advisory role.

The proposed reform could prove decisive in reviving the European project and increasing the resilience and competitiveness of the Eurozone on the global chessboard where massive infrastructural investments are a must. We are 19 different countries but we are supposed (and required) to behave as a unique economic and financial area and risk sharing represents the first step to re-align our diversities. So far, by firstly playing a classical vendor financing strategy and by then deleveraging, Germany has increased its productivity and forced peripheral countries to devalue work to survive in the lack of the re-alignments allowed by exchange rate movements. It’s time for Germany and its closest neighbors to recover some of the risk they have exported and stop claiming that fiscal indiscipline of the periphery is the only cause of its diverging pattern w.r.t. the center.