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Guest post

Risk segregation and market fragility in the eurozone

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By: Guest writer

The following guest post on Italian government bond markets is from Marcello Minenna (http://www.consob.it/web/area-pubblica/minenna-marcello)*, 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.*

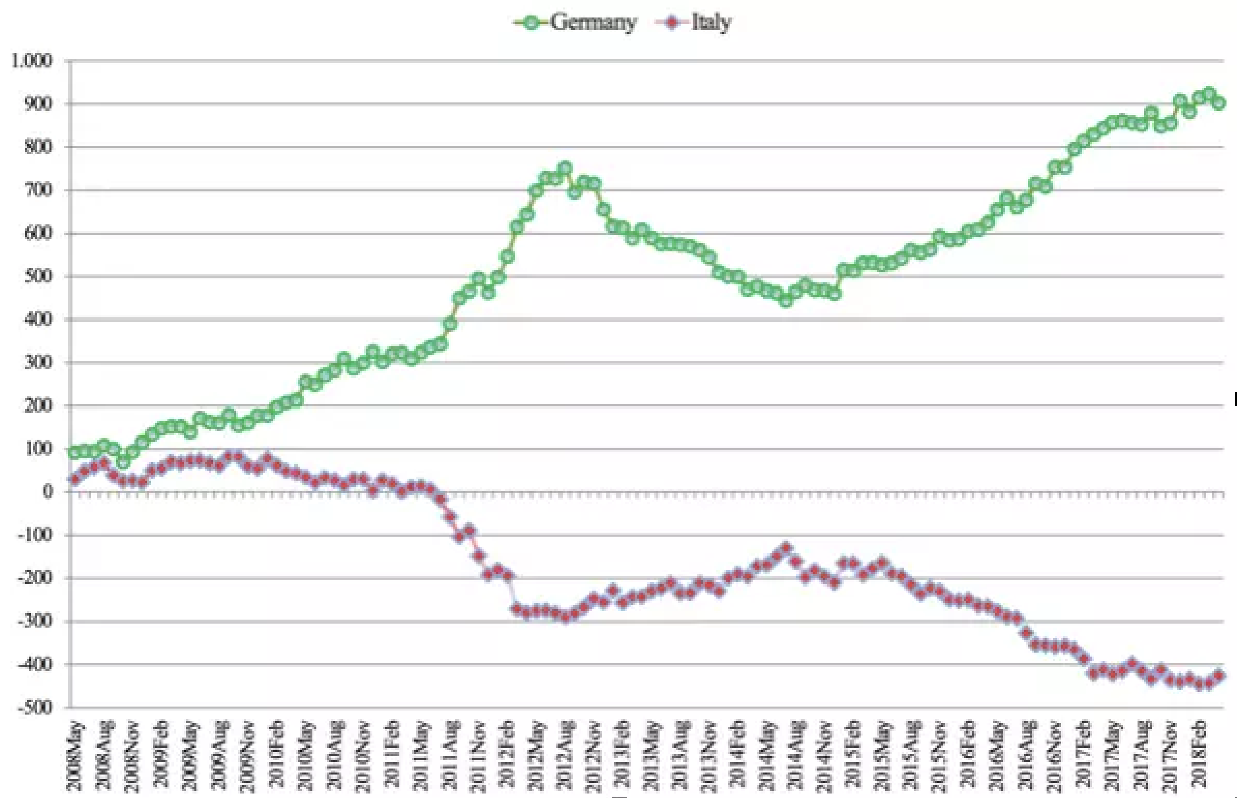
In recent weeks, the sometimes-frantic developments in Italian politics and the responses from its European partners have unleashed a dangerous mix of panic and speculation, which risked becoming a self-fulfilling prophecy until the formation of a new government calmed markets.

Turbulence was initially triggered by leaks of the agreement between the League and the 5 Star Movement, as the first version provided for an exit clause from the euro and the cancellation of government bonds purchased under the ECB's quantitative easing programme. Europe is concerned that the expansive economic policy program of the two parties (estimated expenditures at about €100 billion) will bring the still-problematic Italian public finances back into chaos. Most punitive were the comments and declarations from prominent members (http://www.gata.org/node/18242/print) of the German political and economic spheres, one of whom recently said the ECB should unilaterally impose capital controls on Italy through the payments system, in a type of "Greek cure". Such statements have a disruptive effect on the markets, because they fuel the alarm of prudent investors and the thirst for profit of speculators.

The stakes are very high. In less than a month the Eurogroup and European Council will hold meetings to negotiate the Eurozone architecture reform plan. So far, the discussions about this plan have been essentially a prerogative of Germany, with Macron's France somehow participating in the work. For Germany, the priority is encouraging risk reduction for both banks and sovereign states, and recipient no. 1 of this message is Italy. To understand why we need to look back to 2011: At that time, banks in Germany (and elsewhere) started a massive reduction of their exposures to Italian sovereign risk, forcing Italian banks to nationalize a large share of the public debt of their country. This risk segregation strategy has continued with QE, in which there is essentially no risk sharing and national central banks directly buy securities issued by their respective governments. Today, the Bank of Italy holds over €370 billion BTPs.

But risk segregation has also made it clear to Italians (a country of savers, mind you) that in the monetary union there is no mutual solidarity, and that the extraordinary measures set up by the Euro-bureaucracy against the crisis (such as the Eurozone sovereign bail-out fund or QE) would hardly protect their country in the event of another negative shock. Trust has a value: due to the uncertainty about the future, the liquidity introduced by the QE hasn't remained in Italy. It has instead fueled capital flight to northern Europe (https://ftalphaville.ft.com/2017/09/14/2193700/guest-post-the-ecbs-story-on-target2-doesnt-add-up/), primarily Germany, which carries a balance on Target 2 (the interbank payment system in Europe) that exceeds €900 billion. Italy, on the other hand, runs a deficit of over €420 billion.

Figure 1- Evolution of German and Italian Target 2 balances (EUR billion)



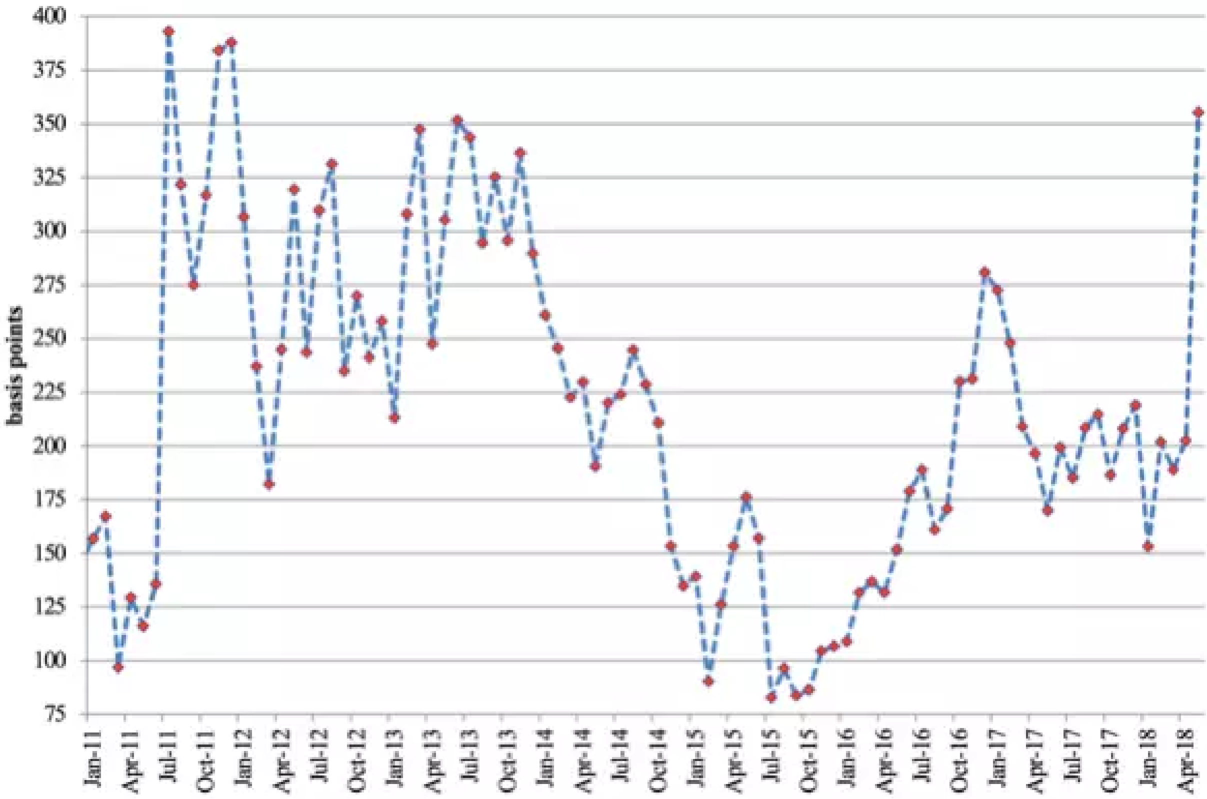
In technical terms, Target 2 balances are only accounting records between central banks of the euro-area countries; given their common membership in the monetary union, they do not even have an expiration date. If, however, a member country were to leave the Eurozone, the problem of settling claims or liabilities towards the others would arise.

In such a context, markets do their job: evaluate the different possible scenarios and assign them a probability. That's why, since May 29's institutional crisis, the Italexit option has regained ground. Although the parties' designated Prime Minister (Cottarelli) was a technician and a supporter of fiscal discipline, the expectation that Italians will return to the polls within a few months and again throw their support behind the League and 5 Stars has increased the perception of *redenomination risk*. In fact, if Italy returned to the lira it could repay its government bonds in the new national currency (much weaker than the euro) and obtain considerable relief on its debt burden. The same goes for the Target 2 liabilities: it is far from obvious that they should be settled in euros. By applying the principle of *lex monetae*, these liabilities could also be repaid in the new national currency, with a huge loss for Germany.

There was also a massive investor deleveraging on May 29, which led to a surge in the risk premium on Italian BTPs together with a collapse of the yield on German Bunds. The 10-year BTP-Bund spread exceeded 300 basis points, the largest since mid-2013.

Moreover, if we consider the BTP-Bund spread in real terms (i.e. net of the inflation differential between the two countries), Italy is again close to the critical levels exhibited during the peaks of the Eurozone sovereign debt crisis. That is notable because over the last seven years, excluding some periods of volatility, we observed that this real spread has traded within a range of 150 to 300 bps. In a sense, this range represents the market-implied Italian sovereign risk over those seven years, signaling that financial agents had not become more risk-averse towards Italy as a member of the Eurozone.

Figure 2 – 10-year BTP-Bund spread in real terms

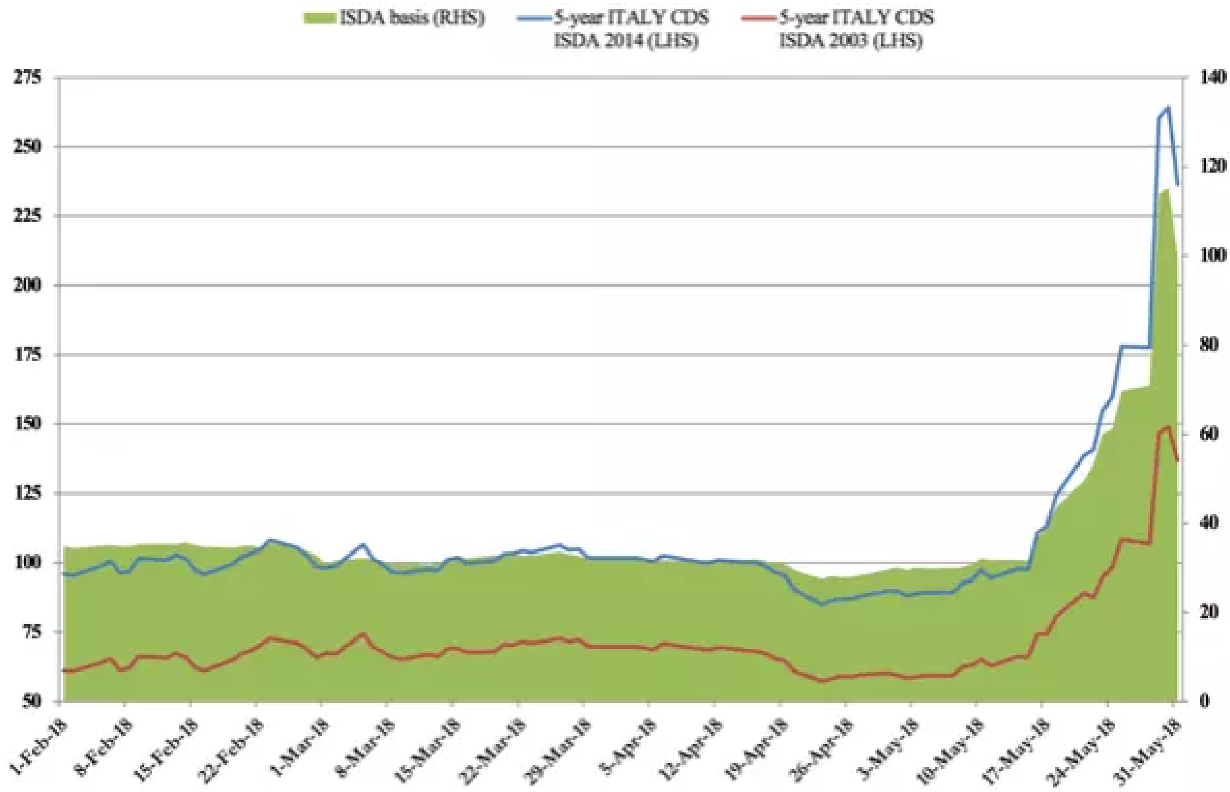


Looking at the whole Italian sovereign yield curve, it is worth observing that over the last month it has experienced a marked upward shift with a flattening on maturities beyond one year. The 2-year yield has exploded: many will remember that when Greece defaulted in 2012, its yield curve inverted because the market for Greek short-term paper was very hot.

Figure 3 – Italian sovereign yield curve

There are also specific [market indicators of *redenomination risk* (https://ftalphaville.ft.com/2017/03/06/2185614/guest-post-cds-markets-signal-rising-fear-of-euro-breakup/)](https://ftalphaville.ft.com/2017/03/06/2185614/guest-post-cds-markets-signal-rising-fear-of-euro-breakup/): the so-called *ISDA basis,* and the spread between *Local Law* bonds and *Foreign Law/CAC* bonds. The *ISDA basis* is the difference between the price of the credit default-swap on a sovereign entity according to the new ISDA standard (2014) and the price of the same contract according to the old ISDA standard (2003). Only the new ISDA standard includes the conversion into a new currency among the credit events that trigger the CDS hedge. Over the last month, Italy's *ISDA basis* has soared from 27.5 to 115 basis points, before returning to 99 bps after the formation of the government led by lawyer Giuseppe Conte.

Figure 4 – Italy: 5-year USD sovereign CDS (ISDA 2014 and ISDA 2003) and ISDA basis

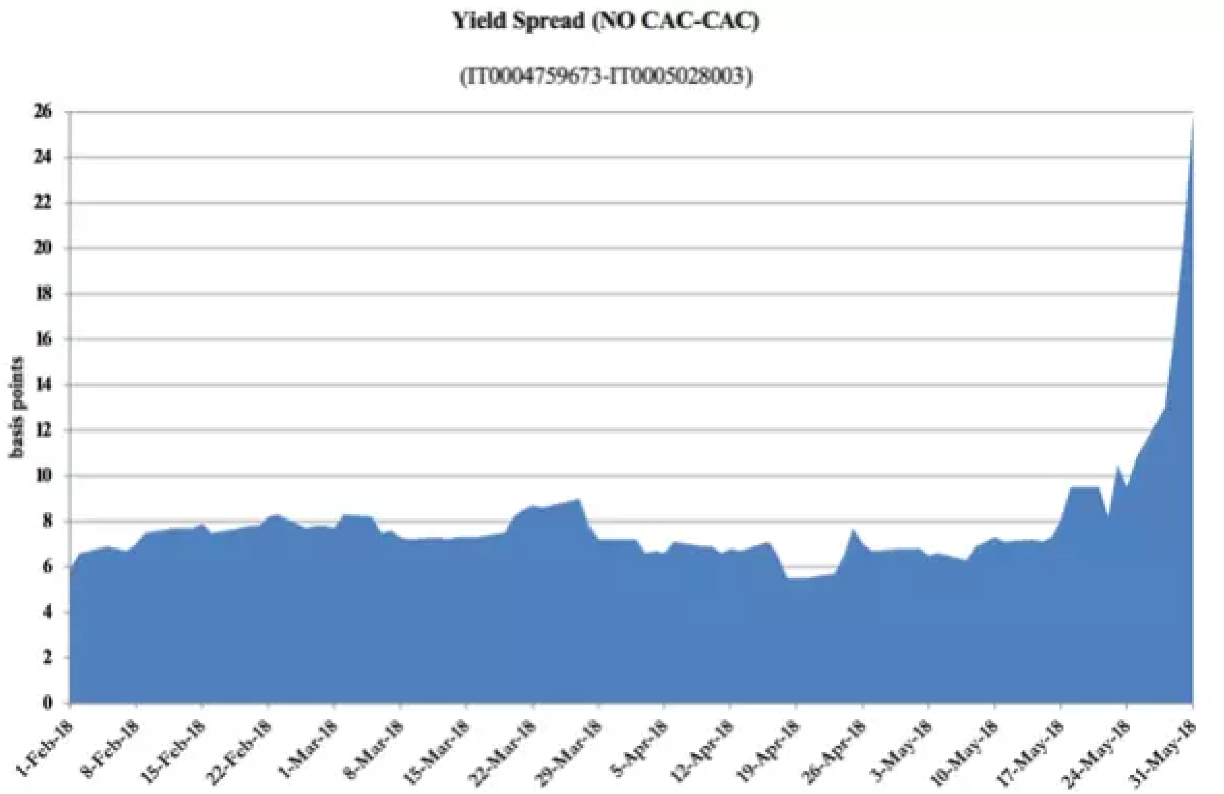


Also the so-called *legal spread* (http://marcello.minenna.it/wp-content/uploads/2017/01/Italy-2017-01-19.pdf), i.e. the yield spread between *Local Law* bonds and bonds under *Foreign Law* or embedding Collective Action Clauses (CACs), experienced similar dynamics. *Local Law* securities can be subjected without problems to *lex monetae*, the universally accepted principle which allows a sovereign issuer to change the currency that has legal tender within its borders and to convert its debts into that currency. But *lex monetae* does not apply to *Foreign Law* bonds, and in the case of CAC-bonds its application could expose the State to a non-negligible litigation risk.

Collective Action Clauses (CACs) have been progressively introduced in the Euro bloc since 2013 on new government-bond issues with maturities one year and greater since 2013. Among other things, these clauses allow a minority of bondholders (25% + 1) to block the redenomination of the involved bonds into another currency.

From the end of April, the extra return required by market players on *Local Law* Italian Govies that do not embed CACs (i.e. those that could be redenominated into Italian lire) and those which, albeit being under Italian Law, incorporate these CAC clauses (i.e. those that are safer because they are more difficult to redenominate) reached a peak of 26 basis points compared to 6 basis points at the beginning of February.

Figure 5 – Yield spread between a pair of Italian Govies with similar time to maturity, the former without CACs and the latter with CACs



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As they said in ancient Rome, *tempus fugit*.

The new Italian government must work well and quickly to prepare for the key international events on the agenda, such as the upcoming meetings of the Eurogroup and the European Council. It is imperative to make international interlocutors understand that risk segregation does not pay, and that sharing the risks – and not just the benefits, including commercial ones – of the single currency is the best way to effectively reduce them and for all.

From this perspective, last autumn I developed a proposal for a gradual mutualisation of the sovereign risks (https://ftalphaville.ft.com/2017/11/21/2195979/guest-post-getting-to-eurobonds-by-reforming-the-esm/) of EMU members. The idea is to gradually introduce the sovereign guarantee of the European Stability Mechanism on the government bonds of the various Euro bloc countries. In return, each country would pay to the ESM a premium corresponding to the market value of the guarantee received: in this way – rather than paying a running risk premium to financial markets – a government would invest in its financial strength and testify to its commitment to maintain the public debt under control. Moreover, the capital strengthening resulting from the premiums collected would allow the ESM to issue investment-grade liabilities to support the relaunch of profitable investments in the peripheral countries, and re-activate the precious link between finance and real economy which is needed to spur durable growth and competitiveness.

The rationale behind risk sharing is quite easy: it is the optimum way out from the redenomination risk or, said differently, to provide the Eurozone the genuine resilience still missing in its architecture.