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ITALY NEEDS A PUBLIC DEBT AGENCY AS THE GERMANY'S ONE

by Marcello Minenna

The controversial reform of the European Stability Mechanism has revived the issue of the vulnerability of Italy's sovereign debt to the markets' speculation.

This brings us back to the hot autumn of 2011 when investors made big profits by betting against Italian government bonds. Many people claim that the episode – as well as the minor ones occasionally occurred after 2011 – is related to Italy's whopping debt-to-GDP ratio.

Although there is no question about that, it is worth remembering that a high debt-to-GDP ratio has long been a structural feature of Italy, which however the country has lived with in a substantially peaceful way before the crisis.

The real problem, brought to light by the crisis, is that joining the euro, the related loss of national monetary sovereignty and the absence of a lender of last resort in the Eurozone – given the prohibition of monetary financing enshrined in the ECB Statute – have made governments hostages to financial markets.

Even before the introduction of the euro, this was clear to many economists such as Wynne Godley who icastically observed that the financing of public spending exclusively on the markets, in competition with businesses, could have proved excessively expensive or even impossible for governments, particularly under conditions of extreme emergency.

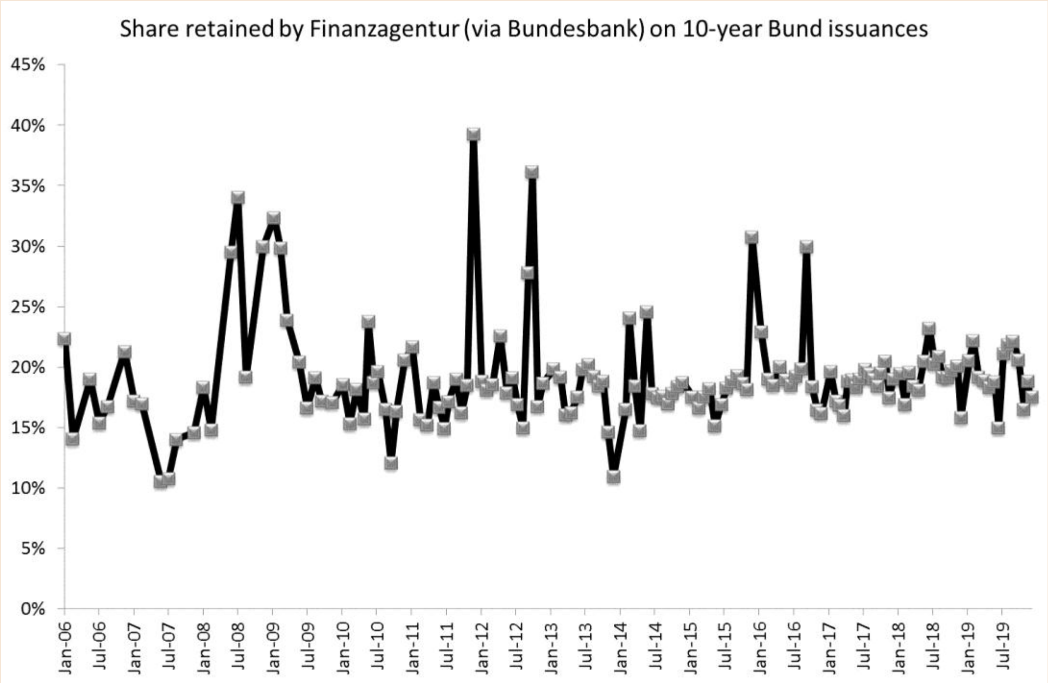
This is a framework that – as I have repeatedly stressed – can be remedied only by introducing risk-sharing between Eurozone countries to be included in a path that also envisages an effective banking union, a double-digit European budget and a fiscal policy that is at least coordinated.

In my opinion, while working to achieve similar objectives, there are initiatives that Italy can undertake immediately and autonomously to mitigate its vulnerability to the markets' '*moods*'.

The idea is to establish a public debt agency directly reporting to the Ministry of Economy and Finance and charged of handling the complete management of the Italian public debt, starting from government bonds' auctions but not only.

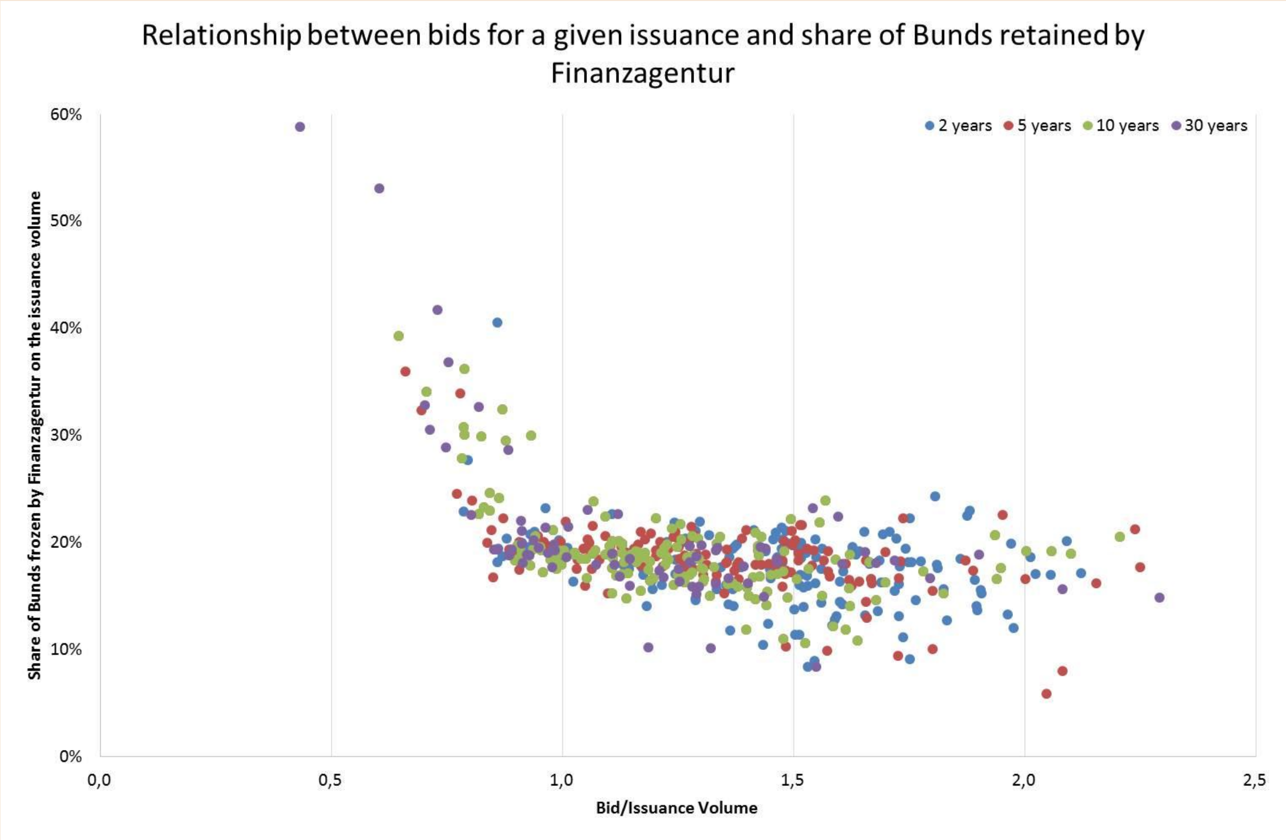
In Germany, a similar agency has existed since 2000 with the name of *Finanzagentur*: it operates as central service provider exclusively in the name of and on behalf of the federal Ministry of Finance. It provides services in connection with the issuance of government securities, the use of derivative instruments, the monitoring and management of public debt risks with the primary objective of continuously guaranteeing the solvency of the German federal government and keeping the debt interest expense as low as possible.

At each auction, the agency retains a variable portion of the amount of bonds issued (so-called retention quote), and commits the Bundesbank to take custody of these bonds for subsequent secondary market operations. On average, this activity includes 20% of the auctioned volume even if the share of the withheld securities has been significantly higher on various occasions: for example, in a 10-year Bund auction occurred at the end of November 2011 – at the peak of the Eurozone sovereign debt crisis – the *Finanzagentur* temporarily frozen 40% of the offered amount.



Formally neither the agency nor the Bundesbank (which operates as its executive arm) purchase securities on the primary market but merely retain them. Nevertheless it is clear that the described operations have a relaxing effect on the auctions' results and on the yields formed on the primary market as well as, indirectly, on those of the secondary market. In practice, the retention acts as a preventive shock absorber, limiting the negative effect of any poor interest of dealers in a given issuance.

An empirical confirmation in this sense can be obtained by comparing the ratio between bids and issuance volume with the share of securities retained by the agency: when the demand is low (bid-to-issuance volume ratio less than 1), the share of retained bonds rises well above the average of 20% of the issuance, *de facto* playing a compensatory function.



The unpredictability of the *Finanzagentur*'s interventions at the auction as well as the uncertainty of the timing of the "re-marketing" of retained bonds on the secondary market by the Bundesbank discourage opportunistic and coordinated behaviors of dealers aimed to tick higher profits.

Obviously, differences between the Italian and German government bonds auctions do not depend only on the presence or not of a public debt agency with retention prerogatives, but also on numerous other factors including the different micro-structure of the two primary markets. For example, Germany uses the competitive auction mechanism that allows to allot the bonds offered at different prices, while Italy uses the marginal auction mechanism in which bonds are allotted to all bidders at the same price (the lowest and, thus, the less convenient for the government).

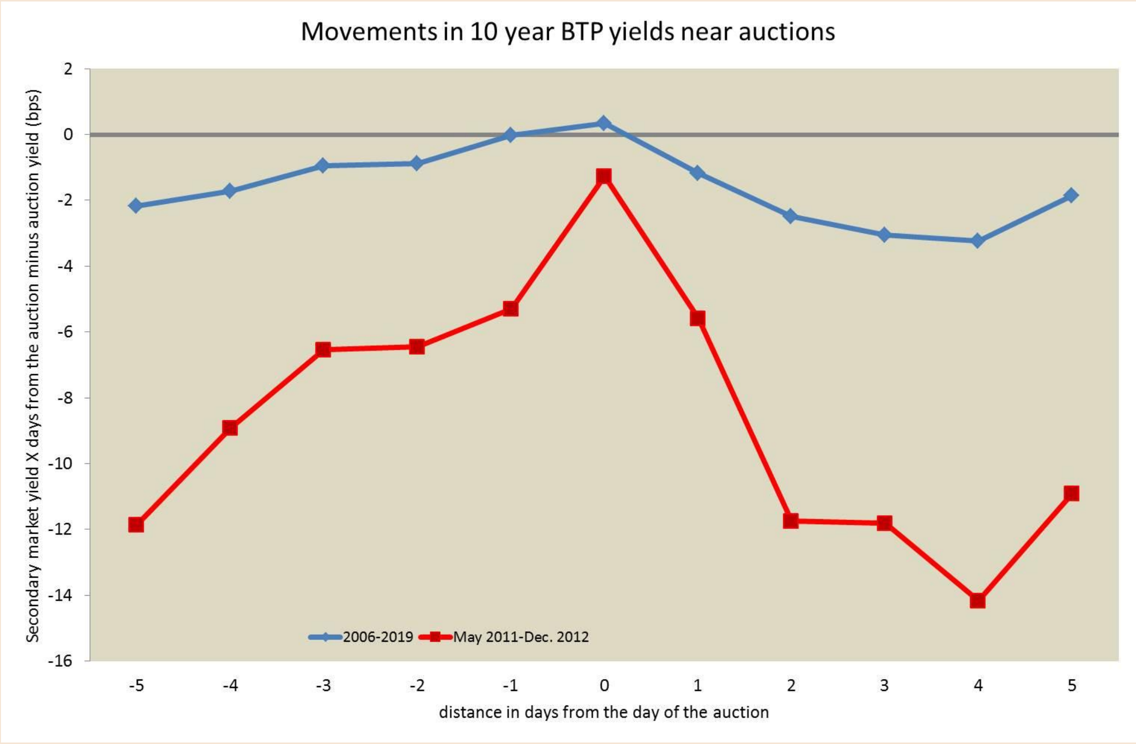
Not to mention the different creditworthiness of the two countries that implies a different inventory risk borne by the dealers who subscribe to a Bund auction rather than a BTP one, especially in jittery markets' moments. The lower the creditworthiness, the greater the inventory risk and, therefore, also the risk premium requested by dealers that contributes to raise yields and not only on the primary market.

A 2013 ECB study has analyzed the auction effect on yields formed on the secondary market of Italian and German government bonds: a key finding was the presence, for Italy, of an 'auction cycle', i.e. a phenomenon such that yields on the secondary market rise in the days immediately preceding the auction and then fall in those immediately following. Graphically, the pattern just described takes the shape of an inverted V. This phenomenon, particularly pronounced in Italy during the years of the debt crisis, was instead smaller in Germany.

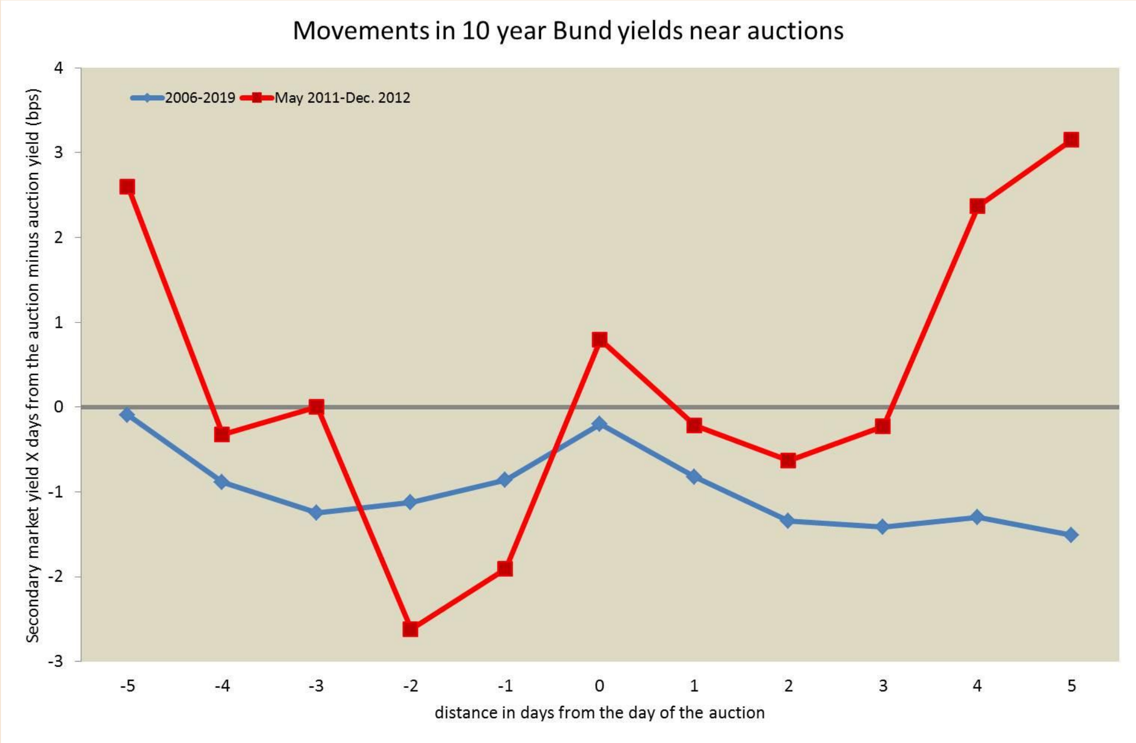
The ECB study focuses exclusively on secondary market yields; but extending the analysis to the yield spread between the secondary market and the primary market near the auction day of 10-year BTPs (the Italian Treasury bonds) shows that the inverted V-shaped pattern holds as well between the two markets.

Under normal conditions, this pattern is not very marked, about 2-3 basis points. But in times of turbulence, it becomes more pronounced, signaling significant changes in the interest rates, concentrated over a few days.

In particular, by restricting the analysis to the most critical period (May 2011-December 2012), it can be observed that in the five days before the auction, 10-year yields rose on average by over 10 basis points and then reabsorbed this upward trend in the two days immediately following the auction itself. Furthermore, over the period considered, the values of the inverted V are all negative, which indicates that yields on the secondary market were constantly lower than those paid by the Italian government in the auction.



In the case of Germany, the inverted V is less pronounced and during the same critical period is strictly limited to the close proximity of the auction.



The different dynamics displayed by Italy and Germany derive from the combination of several factors including, as mentioned, the different auction systems and the different inventory risk of the Bunds compared to the BTPs.

That said, it is a fact that the practice of retention has a calming effect on the behavior of Bund yields near auctions with a benefit for the federal government in terms of lower interest costs of the public debt and also for the stability of the secondary market. Even if officially retention only serves to smooth out liquidity when a given asset is "a little stretched", it allows the German government to finance itself with a reduced exposure to the markets' "*moods*", limiting adverse fluctuations in the interest rates and, thus, saving money.

Returning to the case of Italy, it seems reasonable that, in addition to the inventory risk premium, the movements in BTP yields on the secondary market near an auction date at the peak of the crisis also included a speculative component (albeit hardly quantifiable) due to the attempt of professional investors to make a profit from the relevant information in their possession, such as dates and volumes of issuances.

A public debt agency like the German one would be an effective deterrent for such speculative trades against Italian government bonds and, more generally, a tool to improve the efficiency of the entire public debt issuance and management system. Thanks to the lower vulnerability to the financial markets, the Ministry of Economy and Finance would approach auctions with greater serenity and the government could stably achieve interest savings on debt, especially in particularly turbulent moments. A rough and conservative estimate allows to identify a minimum annual saving of 250 million euros for the Italian government.

Still drawing inspiration from *Finanzagentur*, the advised agency should also deal with all the activities related to the risk monitoring and risk management of the Italian public debt including derivative contracts entered into by the Treasury and whose disappointing performance has contributed negatively to public finance balances (around -4 billion euros a year over the last decade). Not to mention the sizeable contingent liability represented by the almost 40 billion euros of negative mark-to-market on the outstanding derivative portfolio.

The competences in this area would also allow the agency to operate as a risk manager on behalf of local authorities wishing to close their derivative positions or outsource their management to a third party still belonging to the perimeter of public institutions.

Lastly, with the experience gained over time, the agency could also formulate proposals to the Ministry for the revision and optimization of the entire auction process and rules (from the minimum subscription requirements for dealers to the purchase conditions in the days immediately following the auction), always in the perspective of making the debt management more efficient and reducing its costs. For once, looking at how things work in Germany might come in handy.

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