Sunday Wrap

Happy Sunday,

This is Marco Valli from Milan, the UniCredit Chief European Economist. It has been a volatile week in financial markets, which continue to be driven by headlines on the so-called “phase-one” trade deal between the US and China.

In Germany, the SPD party convention that just concluded was probably one of the most important gatherings of the Social Democrats in many years or maybe even decades. Both the SPD‘s participation in the grand coalition and the unity of the party itself were at stake, and with these two issues political stability in Germany and Europe. While political turmoil was avoided over the weekend, substantial tensions within the SPD but also between the CDU/CSU and the SPD are here to stay.

In a nutshell, a large majority of SPD party delegates including the new two party co-heads rejected a breakdown of the grand coalition. However, they made a couple of tough demands: higher government investment spending worth EUR 450bn, or more than 13% of GDP, over the next ten years (thereby calling into question the debt brake); a higher minimum wage of EUR 12 at least in the longer term instead of the current EUR 9.19; and higher unemployment benefits, i.e. a further unwinding of labor market reforms implemented by former chancellor Schröder, a SPD party member, about 15 years ago.

After negotiating these topics with the CDU/CSU, the SPD party executive committee will decide about the continuation of the grand coalition. Needless to say, leading politicians of the CDU/CSU are not happy and already tried to fight off these demands.

Uncertainty is extremely high, but a breakdown of the grand coalition seems (slightly) more likely than not, probably sometime next spring, followed by either a minority government run by Merkel in 2H20 or snap elections. But I will leave that for another day.

Today Erik is taking a break and I will jump in to elaborate on the reform of the ESM (European Stability Mechanism). This topic has raised a substantial number of questions from clients, especially after Italy threatened to veto it, and the BTP-Bund spread widened (moderately). Even though the revamped ESM is far from being perfect, I think it does represent a modest improvement compared to the current framework. A long delay in the timeline for approval and ratification would raise the risk that ESM reform is shelved, de facto leading to stalemate also on other policy areas where action is needed to strengthen the eurozone architecture.

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This is my agenda for today:

- **Key features of ESM reform**
- **Why the political debate in Italy misses the point**
- **What I regard as the real trade-off implied by the reform**

1. Reform of the ESM: key features

ESM reform comes as part of a broader package of measures approved the by eurozone Heads of State in December 2018 with the aim of completing the Banking Union and strengthening the Economic and Monetary Union (EMU). The other parts of this package are a budgetary instrument for convergence and competitiveness (BICC) for the euro area and the creation of a European deposit insurance scheme (EDIS). Work to establish a European capital market union will continue in parallel.

The ESM reform was agreed on by the Eurogroup in June 2019 and a final decision by the Heads of State was initially expected at the EU summit scheduled for next week. However, now that Italy is threatening to veto the reform (and, apparently, not all technical documentation has been completed yet) this timeline will be delayed. Once the reform is approved by Heads of State – current expectations are for this to happen in 1Q20 – the ratification process would start. This requires the green light from the parliaments of all 19 member states of the ESM.

Reform of the ESM is based on four pillars: **1.** a common backstop to the Single Resolution Fund (SRF); **2.** new conditions for country eligibility for precautionary credit lines; **3.** a commitment to introducing single-limb CACs into euro area government bonds, and **4.** a stronger role for the ESM in future financial-assistance programs. I will discuss them in turn.

Backstop to the SRF. This is probably the most important change, which I welcome because it increases consistency and credibility of the single-resolution framework. The rationale for the common backstop is to provide a credit line to the SRF if this is depleted and no other sources of financing are available at acceptable rates.

It is important to recall that the SRF is composed of contributions from banks (and certain investment firms) and has been gradually built up over time, starting in 2016 and with the contribution phase set to end in 2023. As of now, the paid-in contributions amount to EUR 33bn. Germany and France have made about the same contribution to the fund, EUR 9bn each, followed by Spain, Italy and the Netherlands, with about EUR 3bn each. At the end of 2023, the fund should reach its target level of 1% of covered deposits, currently about EUR 55bn (expected to rise to EUR 60bn in four years).

The common backstop will be in place by January 2024 at the latest and will be fiscally neutral over the medium term because if the ESM credit line is drawn, the SRF will repay the loan with money from bank contributions within a maximum time of five years. In the new set-up, the ESM will no longer be allowed to directly recapitalize banks. However, this tool was never used in the past, not even at the peak of the sovereign and banking crisis, when the preferred option was for the ESM to lend to governments (or government-owned vehicles), which, in turn, used this money to recapitalize their troubled banks.

New rules to access precautionary credit lines. These new rules mainly involve the so-called "precautionary conditional credit line" (PCCL), which can only be requested by countries that are “fundamentally strong”, with access to international capital markets on reasonable terms and, obviously, whose government debt is sustainable. If any such “strong” eurozone member state is hit by an adverse shock beyond its control, the PCCL would keep a liquidity crisis from spiraling out of control. This credit line should reassure financial markets and thus reduce the probability that money will be actually disbursed.

Comparing current and new eligibility criteria for a PCCL is not straightforward, but the new conditions appear to be tighter overall, especially when it comes to those regarding fiscal policy. For example, the reform explicitly envisages that for the two years preceding the request of a PCCL, a country would need to record a debt-to-GDP ratio below 60% or a reduction in the differential with respect to 60% at an average rate of 1/20 per year. Currently, among the four largest eurozone countries, only Germany would satisfy these criteria. Tighter conditions will be partially mitigated by the fact that the country that asks for a PCCL will no longer need to sign a Memorandum of Understanding (MoU) and to implement reforms; a letter of intent where the receiving country commits to continue to comply with eligibility criteria would suffice.

If a country does not comply with some of the eligibility criteria for a PCCL, but its economic and financial situation remains “sound”, it can apply for an “enhanced conditions credit line” (ECCL), which requires a MoU to be signed and corrective measures to be undertaken.

Single-limb collective action clauses (CACs). CACs are clauses incorporated into sovereign bond contracts that allow changes to the terms of these bonds, subject to a vote by the bondholders. If a majority of bondholders approves these changes, they become effective for all holders of those bonds. Therefore, CACs should make sovereign debt restructuring more predictable.

Currently, newly issued government bonds in the eurozone carry dual-limb CACs, which require two majority votes to restructure all bond series (where each series features issuance with a certain coupon, maturity, etc.); one vote would be at the aggregate level and one for the issuance of each bond. The new ESM introduces single-limb CACs, which would make it possible to restructure the debt across all bonds' series with just one majority requirement that refers to all the series combined.

Compared to dual-limb CACs, single-limb CACs reduce the risk that a small group of bondholders (the so-called “holdouts”) forms a blocking minority that causes delays in the debt-restructuring process. Under the reformed ESM, member states commit to introducing single-limb CACs into their government bonds issued starting from 1 January 2022.

New ESM role. The reform attributes to the ESM an enhanced role in the preparation and the monitoring of future programs of financial assistance. To some extent, this reflects the evolution of the responsibilities of the ESM. At the early stages of the sovereign debt crisis, the ESM's task was to raise money in the market and disburse it for rescue loans, but over time the ESM has taken on additional responsibilities and has become increasingly involved in policy issues, working together with the European Commission, the ECB and the IMF. It is not surprising that this transformation has been accompanied by increased willingness on the part of the ESM to have a say on whether and under what conditions its money should be disbursed.

2. Why the political debate in Italy misses the point

We are now in a situation where Italy is threatening to veto ESM reform it had agreed upon six months ago. This is how we got here. The League, which did not object to the reform in December 2018 and June 2019 when it was in government, has now decided that, under present conditions, the revamped ESM would be harmful for Italy. Brothers of Italy quickly joined the complaint, creating a united right-wing front that fiercely opposes the reform. This has increased pressure on M5S, which is caught between a rock (nationalistic rhetoric from the right, which still sounds appealing to a number of M5S MPs) and a hard place (the strongly pro-European attitude of PM Conte and the PD). Di Maio, who did not oppose the ESM overhaul when he was in government with the League, has made clear that M5S will not give the green light to the reform unless some amendments are made.

Officially, the reason for such rethinking is the attempt to have the ESM overhaul proceed in parallel with progress on the other two policy areas covered by the broader reform package, namely the common budget and deposit guarantee scheme. Given that the Italian government (rightly) rebuffed the recent German proposal to change the regulatory treatment of government bonds in the negotiations about EDIS, Di Maio thinks that ESM reform should be re-negotiated. Domestic political considerations are clearly playing a big role in this whole discussion, making it difficult to predict future developments.

On Wednesday night, Economy and Finance minister Gualtieri reportedly was able to win some concessions from his eurozone peers, mainly related to technicalities regarding CACs that would allow some flexibility in applying the new framework. I do not know whether this will be enough to regain the support of M5S; we should have a clearer idea next Wednesday, when PM Conte is expected to address parliament on the stance he will take at the upcoming EU summit.

Regardless of the developments of the next few days, the political debate in Italy surrounding the new ESM treaty seems to be missing the real point and some fears appear to be overdone.

First and most important, there will not be any automatic restructuring of government debt when a country asks for financial assistance. This is key because any such automatism would have likely generated perverse self-fulfilling expectations in financial markets and hampered the functioning of the OMT framework. It would have been a recipe for disaster.

Second, concerns that single-limb CACs could increase the probability of Italy having to restructure its sovereign debt are misguided. Yes, CACs are intended to facilitate the restructuring of government bonds, but only once unsustainable trends in financing needs arise due to poor macroeconomic and fiscal trajectories, which make the restructuring unavoidable. The only way through which CACs per se could raise the likelihood of a restructuring is through an increase of interest rates relative to a counterfactual where bond terms do not include CACs. But there is no such evidence.

Literature suggests that CACs have two conflicting effects. From an ex-ante perspective, they can affect pricing via moral hazard – basically, by making a restructuring easier, they lower the bar for the issuers to take such action. From an ex-post perspective, they accelerate the restructuring, which is desirable from a bondholder perspective. Assessing the net effect of CACs is hence an empirical issue. In the eurozone, after almost seven years of experience with double-limb CACs, the presence of CACs has not affected bond pricing to any perceptible extent. My colleague Luca Cazzulani tells me that the average Z-spread difference between BTP 4.50% May23 (with CACs) and the BTP 4.75% Aug23 (without CACs) has been -1bp since January 2015. Similarly, the BTP Sep28 (with CACs) has been trading a few basis points more expensive than BTP Nov29 (without CACs).

Therefore, CACs might be a (tiny) remedy to the pain of restructuring, but certainly are not one of the causes of such restructuring! Moreover, almost all BTP issuance is under Italy's domestic law, which further reduces the relevance of the debate on the exact design of CACs.

More fundamentally, it is naive to think that eurozone peers might one day push for a restructuring of Italy's sovereign debt as a pre-condition for an ESM rescue program, counting on the fact that single-limb CACs might allow containing the systemic shock. A restructuring of Italy's debt is just not going to happen, and there can be no such thing as an orderly (or semi-orderly) restructuring for a systemic country like Italy!

Just think what could happen in the extremely unlikely case that one day Italy's sovereign debt needs to be restructured. One would need to assume that a simple maturity extension or a freeze of interest payments would do little to change the sustainability of the debt, but would instead create turmoil in financial markets, leading the country towards a bad equilibrium where a haircut is needed.

If we assume that in such stress scenario bondholders will probably be largely domestic investors (at least in line with the current share of 70%) and the Italian banking sector would likely account for a large part of the domestic holdings of debt (the current exposure is about EUR 400bn), after some calculations you end up in a situation where the full remaining lending capacity of the ESM (around EUR 400bn) might be quickly exhausted. This would happen because of a big hit to banks' capitalization reflecting both the direct losses on BTP portfolios and indirect effects from the economic and financial damage to firms and households, on top of which one would have to add the money to provide the Italian sovereign with at least one year of funding (currently, this would imply approximately EUR 200bn, excluding BOTs).

My bottom line is this: a potential restructuring of Italy's sovereign debt would be a big shock that could threaten the integrity of the euro area. It makes no sense to think that single-limb CACs might allow easing the pain in the very remote case that such a scenario materializes. I would also expect that all eurozone players would consider every feasible option to keep Italy viable. Therefore, speculation that the ESM's new role in debt sustainability analysis could tilt the balance towards a verdict of restructuring seems totally off track to me.

Since the new ESM set-up does not raise the probability of a restructuring of the Italian debt compared to the current framework, any widening of the BTP-Bund spread driven by fears of the reform should be seen as a buying opportunity. (However, I suspect that this is not the main factor behind the recent widening pressure, which probably largely reflects the heightened political uncertainty and the risk of a collapse of the government coalition.)

3. The real trade-off implied by the reform

I think that the real trade-off Italy should consider when assessing pros and cons of the new ESM treaty is the following. On the one hand, the backstop to the SRF should be regarded as a positive evolution by all member states, including Italy. The reason is that banking crises are to a large extent confidence shocks, and therefore can spread very quickly across countries and financial institutions regardless of how sound their fundamentals are when the crisis hits.

On the other hand, the stronger influence of creditor countries in shaping the conditionality attached to financial assistance could be seen as penalizing Italy, if one assumes that Italy has a higher probability of requesting financial support than most other ESM member countries, and that such conditionality might be tougher under the new set-up than if it only were to be decided by the European Commission (in liaison with the ECB). This comes in a context where the new rules would make it virtually impossible for Italy to access ESM financial support – and hence ECB's OMT – without losing part of its sovereignty in economic and fiscal policies (via the signing of a MoU).

This takes me to the main uncertainty that surrounds the proposed reform, namely the new relation between the EC and the ESM, given the intergovernmental nature of the latter – the ESM board of governors, the highest decision-making body, comprises finance ministers of each member state. More details on the future relation can be found here Joint position on future cooperation between the European Commission and the ESM. In regard to negotiation of conditionality, which I regard as the most thorny issue, the EC should retain a leading role, given its "broad expertise, its role in the Union's economic policy coordination framework and its responsibility to ensure consistency with the Union's legal framework". However, the EC will also "take into account the views of the ESM". How this will work in practice remains to be seen. I tend to think that conditions to access ESM financial support might become tougher under the new regime.

For a country like Italy, the pros and cons of ESM reform probably broadly offset each other. An open political discussion of the real trade-off involved would have been warranted one year ago. Now it is late, as the scope for meaningful amendments to the new ESM treaty is very limited and an Italian veto that remains in place for long would probably delay for the foreseeable future any serious attempts to achieve progress on the common budget and deposit insurance.

Best

Marco

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