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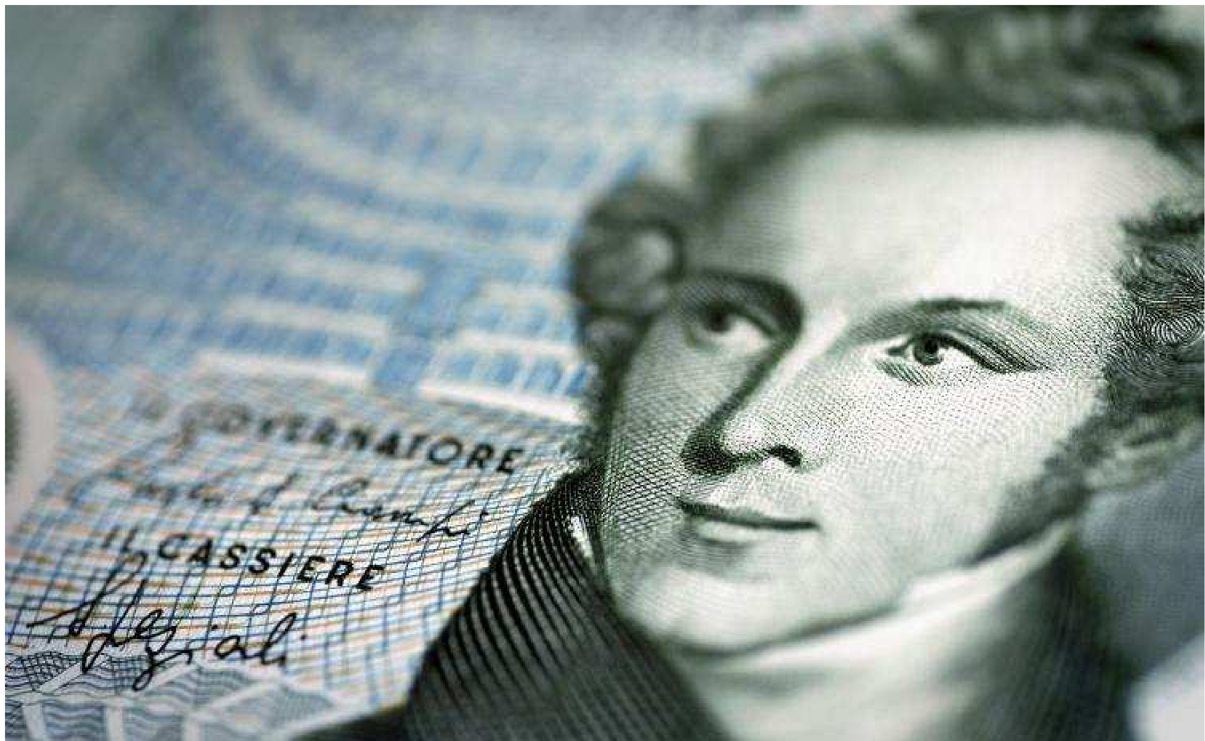
Risk

Draghi's euro-exit redenomination hedge

Marcello Minenna says new ECB policy effectively hedges QE bond purchases



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On January 20, in response to an official question raised by Italian members of the European Parliament, the president of the European Central Bank (ECB), Mario Draghi, admitted for the first time that in the event of a hypothetical exit of a country from the eurozone, the Target2 balances of the central banks involved should be settled in full.

The Bank of Italy owes the eurosystem more than €376 billion ($404 billion), along with Spain (€338 billion), Portugal (€73 billion) and Greece (€71 billion). Germany is, needless to say, the largest creditor among eurozone members, with the Bundesbank sitting on a claim of €747 billion (see figure 1).

In an opinion piece **published on Risk.net in July 2015**, I described the architecture of the Public Sector Purchase Programme (PSPP), which currently uses the eurozone national central banks (NCBs) to buy government assets on a national basis, as an implicit credit default swap (CDS) sold by NCBs towards the ECB. In other words, I was supposing that the Bank of Italy and the other NCBs were guaranteeing that the purchased bonds would have been evaluated at the nominal value, implicitly protecting the ECB against a debt devaluation that would follow the unilateral exit of a member country from the eurozone.

That was a long shot. Reasonable doubts have arisen about the legal framework that would allow the ECB to claim back from national central banks the money created under the PSPP to purchase the bonds, especially after a debt redenomination made by a sovereign state under the cover of the *Lex Monetae* principle, which gives a country the right to choose its currency. But Draghi's statement has changed the situation.

After all, a CDS-like protection does seem in place via the Target2 mechanism. Target2 liabilities would not be subject to redenomination and would be due immediately upon a member state's exit from the eurozone, wreaking havoc on the balance sheet of the debtor central bank. However, the relationship between Target2 balances and the bonds purchased under the ECB's quantitative easing programme requires a little explanation.

Target2 is an accounting system that records payments between private banks. All payments between a country and abroad become a debit or credit between an NCB and other eurozone central banks. Every central bank settles in full the transactions with its national banking system, but there is no form of settlement between the NCB and the Eurosystem.

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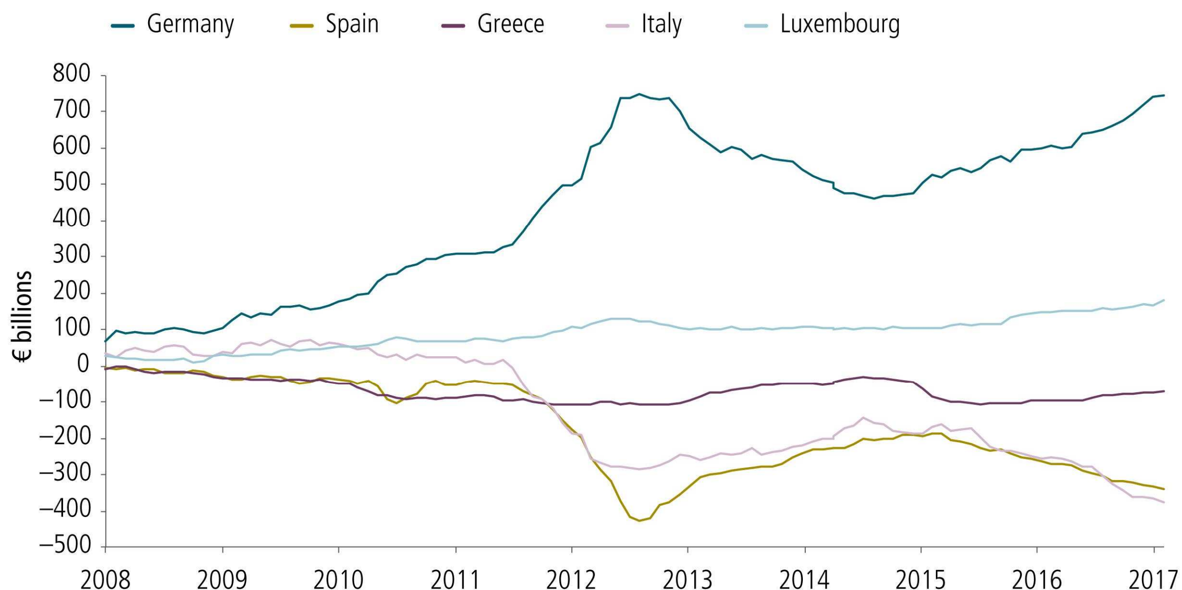
So, if an Italian bank invests abroad – it buys a government bond that a foreign bank is selling or shuts down a line of credit – capital is leaving the country and is included in the Bank of Italy's Target2 account. Since there is no settlement at the central bank level, Italy's Target2 account is becoming increasingly negative. This is a symptom of a moderate but persistent capital flight. The direction? Northern Europe.

In a normal situation, the net balances are simply accounting entries between branches of the ECB. But in the event of a unilateral exit by one of the central banks of the Eurosystem, what would happen resembles the spin-off of a business unit – in this example, the Bank of Italy – from its parent company, the ECB. The Target2 liabilities of a debtor central bank should be treated as intra-group loans and therefore should be paid back, in euros, to the parent company. That sounds consistent from a legal point of view and fits exactly with Draghi's stance.

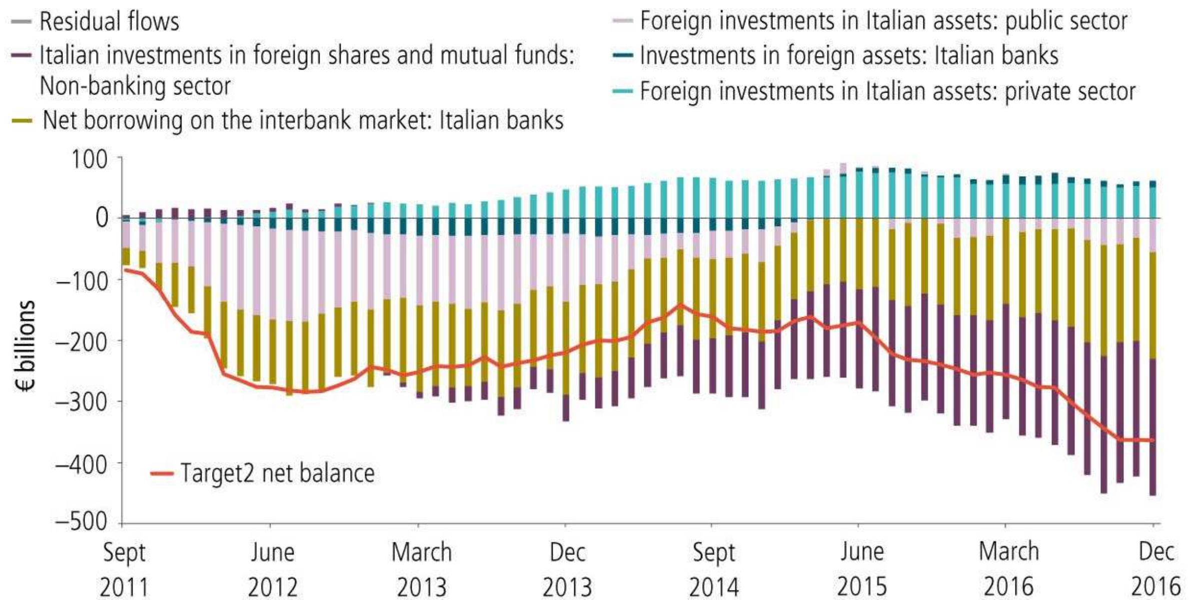
A key point here is that the ECB has played an active role in accommodating the Target2 imbalances by financing the capital outflows with expansionary measures such as long-term refinancing operations (LTROs), targeted LTROs and quantitative easing.



This is not the first time these figures have shown significant divergences: Italy's Target2 net balances reached a negative peak of –€284 billion in 2012. Around that time, foreign banks, German and French ones in particular, sold huge amounts of Italian government bonds – at least €150 billion between July 2011 and December 2012 – to Italian banks, which in turn received the funds from the ECB via the LTRO loans at very low interest rates.

In 2017, it is the Bank of Italy that is receiving money from the ECB under the PSPP to buy government bonds from banks and the non-financial sector. Since 2014, more than €220 billion of mostly ECB funds have been channelled to Italian banks and enterprises in exchange for government bonds. This amount has not been reinvested in the national economy (see figure 2), but instead has been trickling away inexorably month after month towards banks, mutual funds and foreign share purchases by Italian banks and non-financial enterprises in Luxembourg, the Netherlands and Germany.

Only 20% of the €220 billion can be traced back to Italian entities, through investment in what is known as a round-trip fund, where investment is made into a Luxembourg vehicle of an Italian fund manager, for example. The same phenomenon is occurring in Spain, where an outflow of more than €150 billion towards foreign financial assets is well under way.



The persistent outflow can be framed as a strategy to hedge Italy's private wealth from a subtle redenomination risk: that is, the risk that a euro-denominated asset will be redenominated into a devalued lira after an Italian exit from the eurozone.

In fact, if there was a sharp lira devaluation of 20–30%, euro-denominated assets held in northern European banking systems would increase their value. At the same time, the Italian government would benefit from a significant redenomination of domestic law government debt (roughly 50% of the total) in a weaker currency that should reduce intrinsically the debt burden.

However, risks are not disappearing, but are shifting from the private to the public sector through the Target2 mechanism. The hedge that private enterprises and banks are obtaining from investing abroad is actually coming at the expense of the Bank of Italy, the ultimate guarantor of the ECB money that is making this deleveraging possible. From this perspective, the QE architecture via NCB purchases could be seen an effective way to segregate the financial risks of debtor eurozone countries within their national borders, with the Target2 balance seen as a measure of the nationalisation of these risks.

The prohibitive size of these enormous liabilities – around 22% of GDP for Italy – paradoxically increases the risks of a disorderly failure of the monetary union, encouraging an outright default on the amounts due to the ECB. In this case, an Italian exit event would ignite further shocks for the global financial system.

Marcelo Minenna is the author of **A Quantitative Framework to Assess the Risk-Reward Profile of Non-Equity Products***, published in 2011 by Risk Books. The opinions expressed in this article are those of the author and do not necessarily reflect the views of these institutions. The author can be contacted at: marcello@minenna.it*