Europe Flash

EU summit Jan 30: Focus on growth, but mostly rhetoric.

- **The EU summit shows a new focus on growth and employment, but the amounts involved are small and with no detail, providing no solution for the crisis. There was no mention to relaxing fiscal targets**
- **A new fiscal compact will be signed in March by 25 countries, while the ESM is expected to start functioning in July with funds to be determined in March. But these were discounted results**
- **The agreement on Greece's PSI and second package is now expected for the next few days in order to launch PSI by mid-February**

Bottom line: The summit was in line with expectations, which were low. It is another step in the strategy to sign a fiscal treaty in March, in line with German demands. In this respect, an agreement has been reached but few details have been provided on the contents of the pact and the ESM. Although it is positive that growth is the main focus of the summit, the results are scarce, since there is no relaxation of fiscal targets or sizeable new funds. A promising idea would have been to allow countries to stick to their structural deficit commitments, but not to compensate for cyclical slippages in order to avoid a downward deficit-growth spiral; however, this has not been talked upon. The initiatives to promote employment do not sound new and are not convincing, while the amounts involved in growth initiatives are very small in comparison to the sharp fiscal adjustment that many countries in the area will have to achieve in 2012. The strong asymmetry between strong fiscal discipline, on the one hand, and rewards to crisis countries in the form of mechanisms that help to reduce spreads in the short term and revive growth, on the other, still persists. All in all, the support from the ECB will continue to be necessary to avoid further stress.

On Greece, there are not news, and the new deadline for an agreement is now mid-February. On other programme countries (Ireland and Portugal), it is recognised that progress has been achieved and that they will be supported until they can return to markets. Perhaps it is the time to consider the lengthening of any of these programs (Portugal), giving a strong signal to markets that the Greek case was unique.

1. Background: So far, the EU has followed a patchy approach to solving the sovereign crisis

The design of the fight against the sovereign crisis in Europe has been clearly partial and somewhat erratic in several fronts:

The response to the problems of Greece has been slow in recognising the solvency nature of the problem, a situation which has been probably exacerbated by a conditionality programme that was too harsh on fiscal measures and by the lack of compliance by the Greek authorities with such conditionality, or at least its implementation. The second bailout programme, which is key for avoiding a default in March, depends on an agreement with the private sector that imposes a haircut of 50% and could entail a loss of 70% r slightly higher in net present value (originally 21%). This agreement would still keep open two key uncertainties: whether participation by the private sector will be large enough, and whether Greece will remain solvent, since the target of leaving the public debt ratio at 120% of GDP by 2020 is very uncertain even with this PSI (recessionary scenario, lack of effective measures, still large adjustment to do). A participation of the public sector and, to some extent, the ECB in the haircut, or an extension of the amounts agreed for the bailout cannot be discarded.

Dealing with contagion: One major mistake by the EU approach was to involve the private sector in the first place in the rescue of Greece. This area is a clear example of the slow and patchy approach by European authorities, which have prioritised moral hazard arguments instead of providing a large enough backstop to dispel once and for all market doubts on sovereign bond markets. At present, the EFSF has not been used in dealing with contagion, and its substitute (ESM), which is likely to be brought forward to mid-2012, would not be large enough by itself to prevent contagion to a large country, even with the current funds from the IMF.

The EBA requirement of more capital by 2012 was the first large response once Spain and Italy were affected by market doubts, but was the wrong approach 1) It did not deal with the core of the problem in the euro area (mostly sovereign debt, not banking debt), and it did not address the doubts existing in the balance sheets of some euro area banks; 2) By applying haircuts to sovereign bonds in the calculation of capital needs, it increased market concerns on solvency issues, reinforcing the bank-sovereign negative spiral; 3) It intensified the risk of a credit crunch and therefore recession, in a context of closed markets for bank funding, which did not open up with this higher capital requirements.

2. The solution provided in the December summit was focused in a Treaty that ensures fiscal discipline in the future, but without designing a path for a fiscal union

Before the December summit it was broadly expected that the EU authorities would reach an agreement on a reform of the Lisbon Treaty to reinforce fiscal discipline, leaving the door open to more decisive intervention by the ECB in debt markets to reduce tensions. However, the details of the international agreement foreseen (excluding the UK and possibly others) were postponed to the March summit, and the hopes of more ECB intervention were not met. It was a clear example of the, until now, "German" approach to solving the crisis, centred in the idea that fiscal adjustment and reforms are the only way to restore confidence. But this is, in our view, an incomplete approach, as it ignores three facts: 1) Markets are now extremely risk averse and have overshot, therefore requiring bolder actions beyond an approach linked only to deficit reduction; 2) there is a risk of an accident in financial markets, especially linked to a disruptive solution to the Greek crisis, but not only; 3) there is a risk that the fiscal adjustment is deep and too fast and creates a deflationary spiral in periphery countries. The summit did not mention either the possibility of introducing Eurobonds as a way of restoring confidence, conditional on a specific path down the road, and interprets steps towards fiscal union only as a discipline tool and not as joint backing of common debt.

In December it was also agreed that the ESM, which should have substituted the current EFSF as a permanent stability mechanism by mid-2013, would be implemented by July 2012. This is welcome, but does not change things much, as the amount involved (€ 500 bn) is still not large enough as a liquidity "bazooka", and needs to be approved by all countries and implemented. Indeed, the delays in implementing the EFSF are a bad precedent in this respect. The summit also agreed in December to drop the requirement that any future rescue by the ESM would necessarily involve the private sector (beyond Greece), using instead the IMF doctrine in this respect. This is positive, and is an implicit recognition that the PSI in the Greek case was a mistake, but has not been enough to convince investors that they will not be called upon next time. Portugal might become the defining factor in this equation.

To complement the power of the ESM and EFSF, the summit also decided to provide more funds to the IMF (€ 150 bn). This could be complemented by contributions from third countries, to be decided at the G20 summit in February. The IMF estimates that it needs $ 1 tr overall, which implies that an extra contribution of around 350 bn would be needed, assuming that the € 150 bn go to European countries.

At the same time of the summit, the ECB extended the length of its unlimited liquidity provision to 3 years, which was widely used by European banks in the auction of December 21 in view of their prospective difficulties to fund themselves during 2012 and the risk of credit crunch. In particular, the ECB allotted EUR 489.2 bn of liquidity, with demand from 523 banks. However, the amount of net borrowing was around EUR 200 bn. In the second 3-year LTRO, that will be held on February 29th, substantial demand is expected. This time, a broader collateral base will likely apply, although the details of the collateral extension rules have not yet been determined. The ECB is also willing to expand the types of collateral available for such operations, addressing the problem of lack of collateral by some European banks. This extra liquidity has partially helped to ease tensions in sovereign markets, especially in the short end of the curve, but most of it has reverted to the central bank through the deposit facility. All in all, we think that unless further measures are taken, the approach to indirectly intervene in sovereign markets through liquidity provision to banks will not be enough to reduce long term rates as required, although it has undoubtedly given the countries time to address the challenges.

3. Two new elements have surfaced in the debate: a demand for a more pro-growth stance in the EZ strategy and possible further measures by the ECB

More recently, it has surfaced that the ECB has been internally discussing further measures to prop up debt markets. Although it is not clear what this would imply, we think it will consist of measures to repair the transmission mechanism of monetary policy, rather than pure direct intervention in the same way as the Federal Reserve or the Bank of England have done. It is also unlikely that the ECB will take the approach of setting a ceiling for long term rates, which in our view would be an efficient way of intervening in markets at a low cost.

At the same time, growth concerns are increasingly emerging in the debate. On the one hand, the new Italian government, after important fiscal and structural measures, has asked for growth measures to compensate for the downward biased introduced by strong fiscal adjustment. The Spanish government has also been suggesting that fiscal targets could be relaxed in the face of lower than expected growth. On the other hand, the IMF has continued to stress the risk of too rapid tightening in 2012, which could “exacerbate downward risks”. The response so far of German authorities to this debate has been vague so far, pointing only to the possibility of using already available structural funds for this purpose.

4. At Jan 30 summit there were no significant agreements on the issues at stake

EU leaders met on January 30th and agreed on a new Treaty on a fiscal compact and endorsed the ESM, both to be signed in March. However, the agreement was not published and only some details were leaked to the press. It is not clear if the agreement is complete or further details need still to be negotiated. The assessment on the ESM/EFSF lending capacity also will be decided in March.

- Countries will commit to a balanced budget and/or a debt brake in constitutional or equivalent national legislation, and that countries which do not comply with it will be subject to a fine by the European Court of Justice. New voting rules will apply, but they were not disclosed and automatic sanctions are also considered.

- The ESM will be brought forward from mid-2013 to July 2012, as expected. Its constitution will be signed at the next Eurogroup meeting. In March, its final resources will be determined (press reports cite the figure of 750 bn, from the current 500 bn).

- No official declaration on Greece. Mr Barroso declared that they expect an agreement in PSI , that would be launched by mid February, and the second bailout in the coming days.

- Most of the statement is devoted to growth, but there was no mention to the possibility of relaxing fiscal targets this year or to use structural funds for large investment projects.

- A three point strategy for growth in mentioned: 1) focus on creating jobs, especially for the young; 2) helping SMEs accessing credit, freeing up structural funds; and 3) accelerate the implementation of the single market.

- Mr Barroso mentioned that out of the € 347 bn of structural funds, 82 bn still had to be allocated, and they could be used for instance by SME’s to guarantee loans. A total amount of 22 bn, from the European Social Fund not yet allocated, will be used for promoting jobs in the 8 countries with higher youth unemployment rates. In order to ensure the access of SME to finance, they support the idea of strengthening the funding role of the BEI, by using the EU budget to back loans of this institution to small firms.

- It is mentioned that national supervisors and the EBA will ensure that bank recapitalisation does not lead to deleveraging”, and that “supervisors should ensure a rigorous application by all banks of EU legislation restricting bonus payments”. Despite ECB providing liquidity up to 3-years, it is clear that there are increasing worries of a credit crunch in the eurozone. The most recent credit data published for November show a clear deterioration in this respect.

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