Euro summit ends without surprises

News from the financial markets | 27 October 2011

Euro summit ends without surprises

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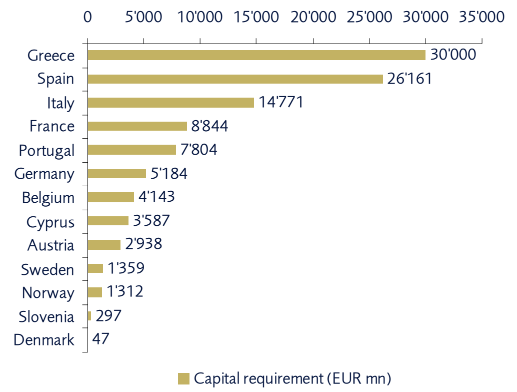
The resolutions adopted at the euro summit were within the range of expectations. The markets sighed a breath of relief on Thursday and an upbeat mood is likely to persist for the next several days. However, the risk of a renewed escalation of the debt crisis cannot be written off. The role of the European Central Bank (ECB) in any further stabilisation measures remains an open question. The volume of the rescue umbrella is limited. Important details on the resolutions are still lacking.

Four fundamental resolutions

The euro zone heads of state and government agreed on four crucial measures:

1. **Greece:** Greek government indebtedness should be reduced to 120% of gross domestic product (GDP) by 2020. In turn, the private-sector banks will voluntarily waive 50% of their claims against the Greek state. Based on our current level of information, private investors will not be obliged to participate. Non-private creditors such as the ECB and International Monetary Fund (IMF) will presumably also not be involved in the «haircut». The European Union (EU) and IMF are to secure the financing of Greece's budget and current account deficits in the coming years. According to their own indications, that will cost at least a further EUR 100 billion.
2. **Bailout fund:** The EFSF safety net will be leveraged up to roughly EUR 1 trillion. The key details of the «partial-cover insurance» on new issues of European government bonds are crucial for a conclusive assessment, but they are not yet known. Also unclear is whether the IMF and other foreign financial backers will participate in a yet-to-be-founded entity that invests in European government bonds. Making new financial aid explicitly contingent on the fulfilment of conditions imposed on the borrowing nations is a welcome development.
3. **Banking sector:** Europe's banks must boost their Tier 1 capital ratio to 9% by the middle of next year. The European Banking Authority (EBA) estimates that the total need for additional capital amounts to EUR 106 billion. If it is impossible for a bank to obtain capital via the financial markets, the individual states and ultimately the EFSF stand ready to provide funding. Moreover the European governments will support the banks' efforts to tap the capital markets by providing state guarantees in order to avoid a credit crunch.
4. **Fiscal policy:** Italy and Spain have committed to concrete measures for a further consolidation of their public finances.

Estimated capital need of private-sector banks



Source: VP Bank, European Banking Authority

Details will determine success

The international financial markets immediately sighed a breath of relief in response to these resolutions, but the debt crisis has yet to be conclusively resolved:

- The plan lacks a «lender of last resort» in the form of the ECB. The popped-up rescue umbrella could quickly turn out to be too small if the spiral of rising interest rates and higher default risks is not halted by these measures. A stabilisation of the Italian government bond market is an important prerequisite for that to happen. But precisely for that purpose, the EFSF is possibly still too small. It remains unclear how much longer the ECB will continue to buy government bonds.
- The conditions for state support in the recapitalisation of Europe's banks are unknown at this point. Given this public sponsorship, the assumption can be made that it will be coupled with codetermination rights on matters such as dividend payments and bonuses. If the concessions are drastic, it can well be that a number of institutions will try to achieve their 9% Tier 1 ratio by shrinking their balance sheets. That would be bad for the European economy. A recapitalisation of the banks in the periphery by overindebted states has little credibility.

- The «insurance» solution poses a number of problems:
  - The default risks are closely interrelated, thus the EFSF will assume only unilateral risks.
  - How generous is the «partial-cover insurance»? The guaranteed portion of new government bond issues must take into account the limited size of the EFSF, but it should also key on the default probabilities. Here lies a risk.
  - How high is the insurance premium?
  - What happens to government bonds (e.g. from Belgium) that are not insured? Will investors sell/avoid them, which in turn would drive the related returns so high that these countries also encounter solvency problems?
  - To what extent do incentives exist for cleaning up their state budgets?

The bottom line:

We welcome the planned, Europe-wide backing of euro zone banks' bond issues as a means of financing the grant of credits to European companies and households. These measures will probably limit the economic costs of the crisis if they are implemented rapidly.

It appears to us that an immediate intensification of the debt crisis has been averted for now. Thus for the time being at least, we are reckoning with a more conducive climate than in recent months for risky asset classes.

Nonetheless, many aspects are still unclear. The open questions will be answered only in the coming weeks, and therein lies the potential for disappointment. Therefore, the risk of a renewed escalation of the debt crisis remains intact.

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