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The European summit

No drama, but a whole heap of uncertainty

Mar 2nd 2012, 19:37 by Charlemagne | BRUSSELS

PRAISE heaven for a boring European summit. “This is my first summit without talk of default, break-up or catastrophe,” said Enda Kenny, Ireland’s taoiseach (prime minister). “We had a normal, constructive discussion.” The French president, Nicolas Sarkozy, went even further: “We are not out of the economic crisis, but we are turning the page on the financial crisis.”

A new treaty (http://european-council.europa.eu/media/639235/st00tscg26_en12.pdf) [PDF] to impose greater fiscal discipline on euro-zone members and eight others (but not Britain or the Czech Republic) was signed today after being negotiated in record time. The fall in the spreads on bond yields of France and others showed the situation was stabilising, said Mr Sarkozy: "It is a great relief." The European Union is now trying to turn its attention to promoting longer-term growth (http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/1 [PDF].

If Europe can breathe more easily it is thanks in large part to two Italians called Mario. First, Italy's technocratic prime minister, Mario Monti (http://www.economist.com/node/21548982) , has started to pull Italy back from the brink through budget cuts and structural reforms.

More importantly, Mario Draghi, the president of the European Central Bank, has administered a double shot (http://www.economist.com/blogs/freeexchange/2012/02/europes-central-bank-and-euro-crisis) of financial morphine—cheap three-year loans to any euro-zone bank that asks for the money—that has eased the acute pain. But the euro zone is far from cured: there are worrisome symptoms all over.

To begin with, Greece has more obstacles (http://www.reuters.com/article/2012/03/01/eurozone-greece-bailout-idUSL5E8E1A1S20120301) to overcome before securing the vital second rescue package it has been promised. Whether it can implement all the budget cuts and reforms it has promised is the subject of great doubt (http://www.economist.com/blogs/charlemagne/2012/02/greek-crisis) . But for now the mood is to push the rescue through; talk of forcing Greece into an early default has died away.

So has the invective against Antonis Samaras, the leader of Greece's New Democracy party, who has often questioned the EU-IMF conditions imposed on his country. Just before the summit, Mr Samaras had a long private meeting with Angela Merkel, the German chancellor.

Both sides said it had gone well. Germany said it was reassured that Mr Samaras would stick with the programme if elected in Greece's general election, expected in April. He said he had voted in favour of it and "paid with the blood of my party" after 21 members were expelled for opposing the EU/IMF demands.

The Greek issue neutralised, for a while at least, there is now a looming clash with Spain (http://www.ft.com/cms/s/0/eabdded8-6462-11e1-b50e-00144feabdc0.html#axzz1nybNMHOm) . As the euro zone enters a double-dip recession, Spain may be coming closer to a deflationary spiral. Its unemployment rate, at 23.3% last month, is the highest in the EU. And its budget deficit last year barely declined from 2010, standing at 8.5% of GDP instead of the planned 6%.

Mariano Rajoy, the new Spanish prime minister, has been lobbying for his country’s deficit target to be softened, but the summit was having none of it. The conclusions declare: “Member States under market pressure should meet agreed budgetary targets and stand ready to pursue further consolidation measures if needed.”

A novice in European summits, Mr Rajoy has been playing a strange game. He was careful not to discuss specific figures with fellow leaders. But as soon as he emerged from the summit he declared that Spain’s deficit this year would be 5.8%, rather than the agreed target ratio of 4.4%. He insisted, though, that Spain would still fall below the 3% deficit limit in 2013, as planned.

The question now is how strictly the European Commission will interpret its new powers to monitor national economies and demand reform, backed with the threat of semi-automatic fines. Senior figures in Brussels say they could in theory live with a Spanish slippage this year.

But they are wary of undermining the new governance system, and of giving recently becalmed markets a new reason to panic. After all, Belgium was recently forced to make additional cuts to meet its target, and Italy has also made more cuts to balance the budget by next year.

Germany, moreover, seems to be in an intolerant mood. There is irritation that the Spanish government is delaying its budget pending regional elections in Andalusia that Mr Rajoy's party hopes to win, and suspicion that it is inflating last year's deficit figures to blame its Socialist predecessor. The commission says it wants to double-check the numbers. But a senior source in Berlin puts it more bluntly: “Everybody knows the Spanish are lying about the figures.”

The recession has now reached the Netherlands, causing some *Schadenfreude* in Brussels. The Dutch, after all, have been the most abrasively hawkish of the northern creditor governments. The latest official forecasts (http://www.google.com/hostednews/afp/article/ALeqM5jgo6lrVih4Limaky7E docId=CNG.4f45fdff3292f10f96f9f9caed149d3e.1a1) show that, on its current course, the Netherlands would post a deficit of 4.5% of GDP this year, falling to 3.3% in 2015. In other words, it would miss its aim to come below the 3% target next year.

Mark Rutte, the Dutch prime minister, says he is determined to bring the deficit into line, not because the EU is telling him to do so but because he believes in budget discipline. But it is unclear how he can do this, and whether the anti-immigrant and anti-EU Freedom Party of Geert Wilders will continue to prop up his minority government.

Political uncertainty comes from other directions, too. Ireland has called a referendum (http://www.economist.com/node/21549016) to ratify the fiscal compact. Mr Kenny has expressed confidence that Irish voters, who have twice rejected European treaties, will vote "yes" this time. Moreover, François Hollande, the French Socialist presidential candidate, has said he would renegotiate the treaty if elected in May.

A final unsettling factor is the unresolved question of whether to enhance the euro zone's rescue funds (http://www.economist.com/node/21548960) . The easiest way of doing this would be to allow the current temporary European Financial Stability Facility to continue using its leftover funds when the permanent European Stability Mechanism comes into force this summer.

Germany has argued that the current firewall is sufficient given the greater calm in the markets, but has agreed to review the matter by the end of the month. It is under pressure from key members of the IMF who insist that the euro zone must strengthen its firewall before they agree to contribute more money.

For now, though, European leaders are glad to talk of promoting growth, though they mean very different things by the term. The most obvious means of achieving this at a time of austerity is to open up the EU's single market, particularly in services.

Mario Monti, the Italian prime minister, says that as well as a "fiscal compact" the EU needs an "economic compact". Along with Britain, Sweden and others, he is pushing for the performance of countries in market liberalisation be monitored more closely. The summit communiqué calls for a "scoreboard" to compare the performance of member states, and "regular monitoring" in future summits.

This could set up a potential future clash between northern liberals, now backed by Italy and Spain, against France and Germany, that for the most part prefer to protect the services industry. Mr Sarkozy, for one, says he will not have a repeat of the hated Bolkenstein directive that partly liberalised services and led to controversies about the legendary "Polish plumber". German officials like to mock Britain for placing too much emphasis on financial services at the expense of industry.

The leaders have many reasons to engage in happy talk about the euro zone turning the corner: Mr Sarkozy is campaigning for re-election, so wants to take the credit for saving the euro; Mrs Merkel wants to get the world to stop asking for more money; Mr Monti wants to break the Franco-German duumvirate by building alliances with northern liberals on the issue of the single market; Ireland and Portugal want to distance themselves from Greece; and many want to avoid structural reforms that may be even harder than cutting budgets.

Above all, they all hope they can change perceptions. “This is a psychological crisis,” says one senior source, “It is a matter of confidence. The consumer has abdicated. When you keep hearing talk of Greek default and the end of the euro, you will save your money rather than spend it.”

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The euro zone crisis

When is a default not a default?

Mar 1st 2012, 13:56 by Buttonwood

YOU know when you try to claim on your car insurance and it turns out that the policy only pays out if your car is crashed into by Elvis Presley riding Shergar? Greek creditors might feel that way today. The Greeks aren't paying private sector creditors back in full or anything like it (the loss in net present value may be up to 75%); and "not paying a debt back" might seem to be a common sense definition of default.

But here is a ruling (http://www2.isda.org/newsroom/press-releases/) from the International Swaps and Derivatives Association which says that credit default swaps, an instrument designed to insure against just such an event, will not be paying out. Or rather it makes a statement in insurance company legalese that goes

> *The EMEA DC determined that it had not received any evidence of an agreement which meets the requirements of Section 4.7(a) of the 2003 Definitions and therefore based on the facts available to it, the EMEA DC unanimously determined that a Restructuring Credit Event has not occurred under Section 4.7(a) of the 2003 Definitions.*

That pesky Section 4.7(a). The issue seems to be whether the deal is forced or voluntary; if the latter, then a credit event (triggering a payout) has not occurred. In theory, the Greek deal is still voluntary although lots of arm-twisting may be going on.

The people who decide on these things are the members of a determinations committee (http://www.economist.com/node/18775351) comprising ten bankers and five investors. In theory, that might suggest the investors could get overruled. In practice, any decision not backed by 12 members would go to an independent review committee. Since this decision was unanimous, it seems as if the rules were unambiguous; the Greek deal is not a credit event.This will be good news for European politicians who have been desperate not to allow the Greeks to trigger a credit event and reward speculators who had bet on Greek insolvency by purchasing credit default swaps.

Still there is scope to change, particularly if the Greeks invoke a collective action clause that could force all investors to accept the deal. The committee notes that

> *the situation in the Hellenic Republic is still evolving*

and that the ruling is not

> *an expression of the EMEA DC's view as to whether a credit event could occur at a later date*

In short, Elvis could still be over the horizon.

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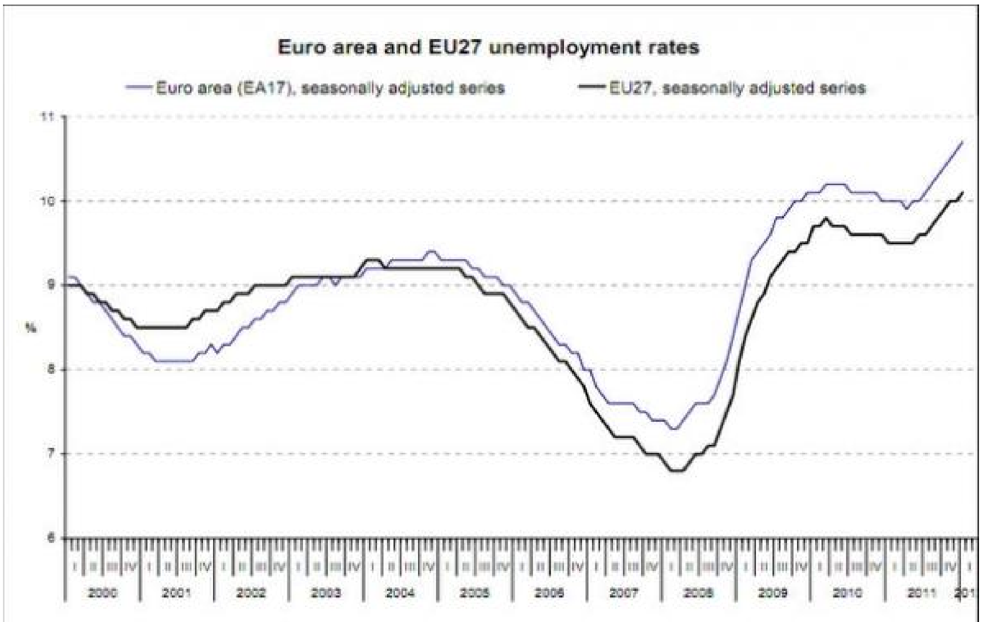
The euro crisis

Worse and worse

Mar 1st 2012, 15:16 by R.A. | WASHINGTON

THE European Central Bank has ridden to the rescue, the yields on Spanish and Italian 10-year debt are back below 5%, and all is well again, no? No:

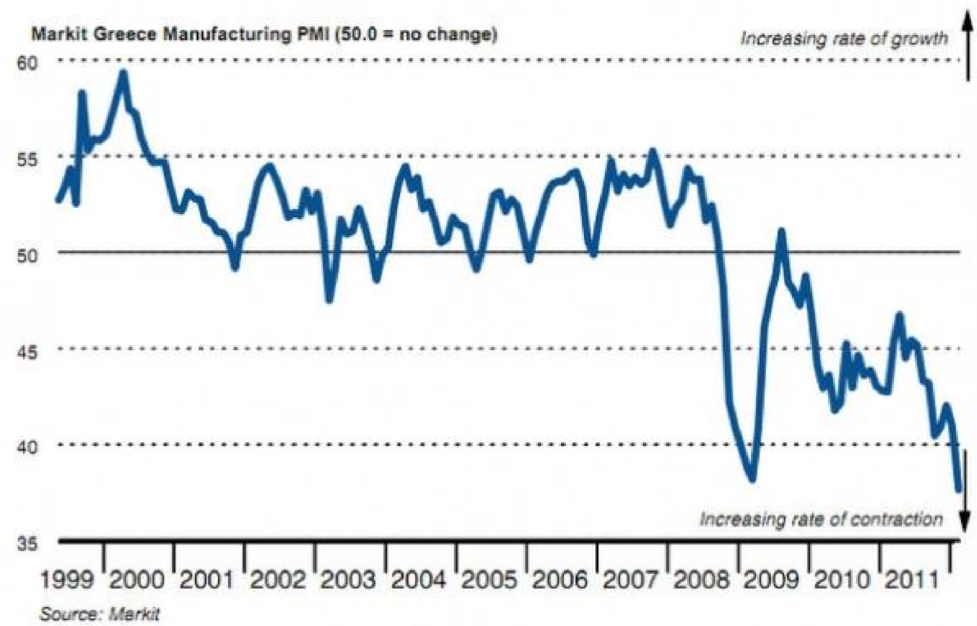
Euro-zone



unemployment (http://epp.eurostat.ec.europa.eu/cache/ITY_PUBLIC/3-01032012-AP/EN/3-01032012-AP-EN.PDF) continues to hit new record highs. Across the single-currency area, the rate rose from 10.6% to 10.7% in January. German unemployment actually moved up a bit, and the rate in France is back in double digits. The levels for Ireland, Italy, Portugal, and Spain are, respectively, 14.8%, 9.2%, 14.8%, and 23.3%. All represent increases from December.

In February, manufacturing activity (http://www.markiteconomics.com/MarkitFiles/Pages/ViewPressRelease.aspx?ID=9206) across the euro-zone continued to contract, albeit at a slower pace than in January. The best performances were in the north; German activity dipped a bit, but declining activity in France has come to an end, for now at least. Contraction continued in Italy, Spain, and Greece. In Spain, the pact of decline actually worsened in February. And in Greece? Well, see for yourself (http://www.markiteconomics.com/MarkitFiles/Pages/ViewPressRelease.aspx?ID=9193) :

Greek



manufacturing activity has contracted for 50 consecutive months, and yet as of February the pace of decline was the worst in its history.

It is difficult to pay your debts when your economy is shrinking. The worse peripheral recessions become, the more markets may fear a Greek -like outcome for others. Italy looks surprisingly resilient these days. Unfortunately, the same cannot be said for Portugal and Spain, two big dominoes.

Beyond financial crisis worries, it's worth pointing out that there is a substantial human costs to long periods of economic weakness. European society and politics will be the worse for this outcome. While we may thank Mario Draghi for preventing a sudden euro-zone collapse, it should be clear that the ECB ought to be acting far more aggressively to fight what is clearly now a euro-zone recession.

« The ECB's LTRO and the Fed's testimony: How to read a central bank
Currency: The kind of money matters »

The Economist

The euro crisis

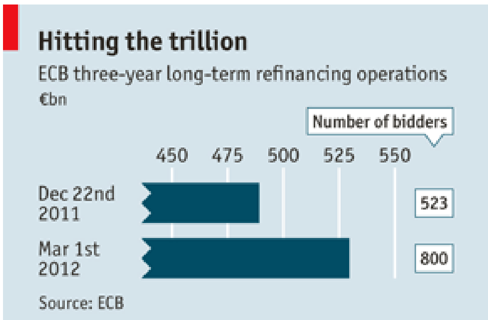
A firewall full of holes

The euro zone’s rescue strategy still does not add up

Mar 3rd 2012 | from the print edition

THERE is a new swagger among European financial officials these days. As bond spreads narrow, share prices rise and the euro strengthens, many policymakers are convinced the crisis has been solved. At a G20 gathering of finance ministers in Mexico City on February 25th-26th, for instance, the European delegates were touting their success. It is a far cry from the browbeatings they suffered during 2011.

This mood of confidence can largely be credited to the European Central Bank (ECB) and its provision of liquidity to banks. But add in Greece’s second bail-out deal, tough new euro-zone fiscal rules, bold reforms in Italy and Spain and—so the argument goes—it is clear that the Europeans are serious about fixing their problems. Just in case, the imminent introduction of the European Stability Mechanism (ESM), a permanent rescue fund, as well as an increase in the IMF’s resources, also mean that a solid firewall is being erected to cope with another conflagration.



Unfortunately, with one exception, every part of that argument is weaker than it looks. The exception is the ECB’s Long Term Refinancing Operation (LTRO), which provides banks with three-year liquidity at its main interest rate, currently 1%, against a wide array of collateral. On February 29th the ECB announced that it had lent another €530 billion ($712 billion), taking the amount of three-year money it has pumped into the banking system over the past two months or so to more than €1 trillion (see chart). It is hardly surprising that markets are perkier.

The amount lent at the second auction was slightly higher than expected, and went to far more banks than the initial auction in December. Since so many small banks have now tapped LTRO, hopes are rising that as well as slowing the pace of bank deleveraging and propping up sovereign-bond markets, the liquidity may encourage new lending to the real economy.

It might, but all that money could also have nasty long-term side-effects. Hawks at the ECB are already muttering about the problem of banks becoming addicted to cheap central-bank funds. And by encouraging Italian or Spanish banks to buy their governments' bonds, LTRO reinforces the close links between the peripheral economies' sovereign debt and the health of their banks.

LTRO has bought time, however. So, too, has Greece's latest rescue package. Germany's Bundestag approved its share of the funds on February 27th. The temporary downgrade of Greek bonds to "selective default", as a result of moves to restructure private creditors' debt, has caused few ripples. In the short term a chaotic default has almost certainly been avoided. But few believe the Greek rescue plan will actually work. Eventually Greece will either need more help from its rescuers or will face default and perhaps an exit from the euro.

What matters, therefore, is how well the euro zone uses the time it has bought itself. The signs are worrying. Policymakers' overwhelming (and misguided) focus on budget austerity is facing increasing resistance. Spain announced on February 27th that its 2011 budget deficit, at 8.5% of GDP, was even bigger than first expected. It wants to renegotiate the 2012 deficit target of 4.4% of GDP.

More worrying still is the lack of progress in building permanent defences against a loss of confidence in another sovereign's bonds. Much faith is placed in the ESM, to be launched on July 1st. This €500 billion fund is supposedly stronger than the current iteration, the European Financial Stability Facility (EFSF), because it is enshrined in legal treaties and because €80 billion of its capital will eventually be paid in, whereas the EFSF relies on guarantees. Although Germany still resists, most euro-zone members hope to run both funds simultaneously, which implies a theoretical cash-chest of €750 billion.

The trouble is that this money is not actually to hand. The EFSF, whose AA+ credit rating was put on negative watch by Standard & Poor's this week, must find its funds in the bond markets, and there is little evidence that it can raise a lot of money fast. And cash-strapped countries, such as France, are reluctant to pay in a lot of capital to the ESM quickly.

The Europeans' reluctance to put a hefty amount of real money at risk has weakened the second part of the firewall, the IMF's resources. In Mexico City G20 members made it clear that they would not stump up cash for the fund until there was a "credible" commitment from Europe.

Worse, even if it were fully in place, this is still a rather flimsy sort of defence. Relying on vast infusions of money from the IMF could actually worsen the problems of a country like Italy, since the fund's presumed preferred-creditor status would push private bondholders further down the pecking order. Nor are the amounts being talked about enough to remove the risk of panic. As Willem Buiter of Citigroup points out, the weaker members of the euro zone collectively need to borrow some €2 trillion over the next two years.

To get properly on top of its debt problem, Europe needs to be bolder. A growing chorus argues that this must entail some form of joint liability for countries' debts. A proposal from the German Council of Economic Experts for a European Debt Redemption Fund, which would mutualise all euro-zone members' debts above 60% of GDP, with strict rules to pay them off over 25 years, is gaining traction in some quarters. Germany itself remains staunchly opposed to anything that smells of Eurobonds, and the current period of calm has only reinforced that resistance. Meanwhile, the clock ticks.

from the print edition | Finance and economics