No answers from European summit meeting

Nick Beams
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Few concrete details of a supposed eurozone rescue plan have emerged from the European leaders' summit held in Brussels on Sunday. It is clear that none of the fundamental problems has been overcome, putting in doubt the unveiling of a "final plan" at a further summit meeting on Wednesday.

The three key issues confronting the eurozone leaders are: the bailout of Greece and the threat to the European and global financial system that a default poses; recapitalisation of the European banks to meet their expected losses on holdings of Greek and other European sovereign debt; and measures to boost the efficacy of the European Financial Stability Facility (EFSF) to cover further crises, possibly in Spain and Italy.

All three issues have sparked differences between the major powers, above all between France and Germany, and these were again evident as the summit began. French President Nicolas Sarkozy declared: "Between now and Wednesday we have to find a solution, a structural solution, an ambitious solution and a definitive solution. There's no other choice."

German Chancellor Angela Merkel's remarks were more muted: "On Wednesday, it won't be the last step that we will take... there will be many steps to be taken."

The two leaders managed to agree on one question: austerity measures against the working class had to be stepped up. The immediate target was Italy, as Merkel and Sarkozy demanded that Prime Minister Silvio Berlusconi carry out previous agreements on budget cutting and "structural reforms" of the Italian economy. The European Commission declared last week that these measures had to be treated "as a matter of urgency."

On the crucial question of Greek debt, a report issued to the summit showed that the previous bailout plan, agreed to just three months ago, has been a complete failure. Under the July 21 package, private investors were to take losses of 21 percent (a "haircut") on their bond holdings while the eurozone countries and the International Monetary Fund (IMF) were to provide an additional €109 billion in bailout loans.

Such has been the impact of the austerity measures on the Greek economy that this plan—heralded as a solution—is a dead letter. If the commitment to the banks that they take only a 21 percent haircut were retained, it would now require the injection of an additional €252 billion. Alternatively, if the original loan commitment were retained, the banks would have to take a haircut of up to 60 percent.

During the summit, Italian treasury chief Vittorio Grilli held talks with representatives of the Institute for International Finance (IIF), the consortium of global banks, on the level of cuts they would be prepared to accept. IIF managing director Charles Dallara, who has previously denounced moves to increase the size of the haircut, said the two sides were "nowhere near an agreement." If agreement cannot be reached and the cut is imposed, the financial crisis could intensify as credit default swaps on Greek debt, estimated to total around €80 billion, come into play.

The only solid agreement appears to be that European banks should strengthen their balance sheets to lift a crucial measure of financial stability to 9 percent by 2012, instead of by 2019 as previously required. This will require a recapitalisation of the banks to the tune of at least €100 billion, financed largely from government funds.

While there appears to be agreement among the European governments, the major banks, especially in Germany, have opposed the plan because of the decline in their share prices. They have threatened to meet the required ratios by reducing their assets. The effect of such a move would be to impose a harsh contraction of credit across the eurozone economies.

The key issue at the summit was the extension of the EFSF's capacity to organise bailouts. The major sticking point has been French insistence that the fund should obtain a bank licence and be backed by the European Central Bank (ECB). This has been strenuously opposed by Germany, as well as the ECB itself.

In the face of this combined opposition, France appears to have backed down. But there has been a concession to its concerns that German proposals for the EFSF to provide insurance on 20 to 30 percent of the value of government bonds will not be enough.

A new proposal has emerged from the summit which will be further discussed in the lead-up to Wednesday's meeting.

Under the plan, the eurozone countries would set up a special purpose vehicle (SPV) to buy Italian and Spanish bonds. In addition to the European countries, the SPV would include money from the IMF, as well as from Brazil and China. A senior official involved in the talks told the *Financial Times* that the SPV could be run in parallel with the insurance scheme in order to provide more firepower and flexibility. Taken together, the SPV and the insurance measures could provide an additional €1,000 billion to counter the debt crisis.

The proposal may run into opposition from outside the eurozone. Both the US and the UK have opposed the provision of additional IMF funds, insisting that the eurozone leaders must provide the necessary financial resources.

There are also concerns that the SPV could be a new source of instability. The proposal has come under stinging attack from *Financial Times* columnist Wolfgang Münchau. In a comment published today under the headline "Europe is now leveraging for a catastrophe," he warned there was a significant probability that the euro could not survive in its present form. This was not because of a failure of the eurozone leaders to reach an agreement, but because of the consequences of the agreement toward which they were moving.

Leveraging of the EFSF, he wrote, was attractive "for the same reason that subprime mortgages once appeared attractive to borrowers." Leveraging could have economic functions but "in these cases it simply disguises the lack of money." The proposal to turn the EFSF into a monoline insurer (that is, providing insurance for a particular asset, in this case sovereign bonds) recalled the role played by monolines during the lead-up to the financial crisis that erupted in 2007-2008. They had insured "toxic credit products" and ended up as a "crisis amplifier."

According to Münchau, the insurance for government bonds up to an agreed percentage sounded like a "neat idea"—until the detail was examined. The value of the insured bonds depended in part on the credit rating of the EFSF, which in turn depended on the credit rating of its guarantors, the eurozone governments. In the likely event that France lost its triple A rating, the value of the bonds would fall, reducing the value of the insurance, whereby "the construction could ultimately collapse."

Münchau concluded by noting that "the chance of a catastrophic accident is bigger than merely non-trivial" and "the main consequences of leverage will be to increase that probability."