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EU summit: Resolution to remain elusive

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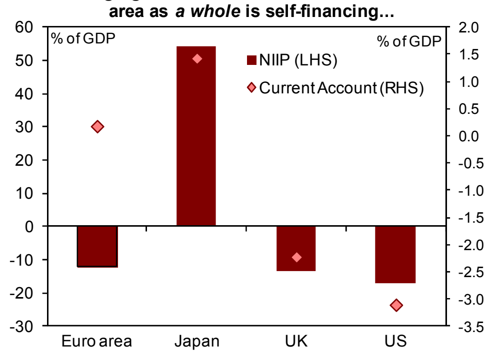
Realism dictates that the EU summit on June 28-29 is unlikely to produce the 'quantum leap' in governance required to create a more stable and workable Euro area. While EU leaders may aim to articulate their vision of what that new regime will look like as an anchor for market and public expectations, the credibility of any such vision will be low, given past missteps and ongoing cross-country disagreements. In short, crisis resolution will remain elusive.

At the summit, we expect to see finalisation of the much-anticipated growth compact, involving financing for infrastructure investment and a restatement of the agenda for structural reform. We also expect announcement of a plan for 'banking union' in the Euro area, even if, owing to unresolved political differences, details are likely to remain sketchy on key issues—notably on how the implicit cost of providing fiscal backing for the Euro area banking system will be shared across countries.

These initiatives are worthy in themselves and represent contributions to the long cumulative process of institutional reform required in the Euro area. But they are not, of themselves, game changers. Nor do they address the immediate challenges thrown up by ongoing and intensifying market tensions.

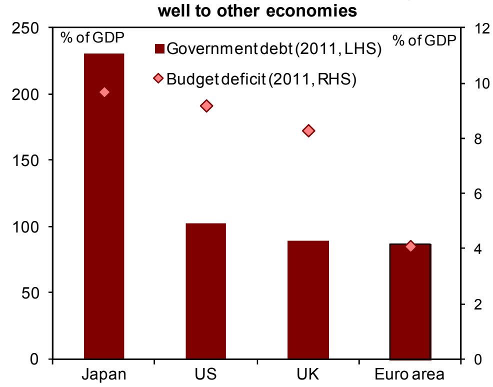
One way or another, the ECB balance sheet will remain the main vehicle to 'muddle through' these pressing challenges: further 3-year LTROs, further widening of eligible collateral and expansion of TARGET 2 balances are likely tools. As we have seen in the past, none of this represents a resolution to the Euro area crisis. Resolution awaits more far-reaching decisions on fiscal and political integration, which experience suggests are only likely to emerge under market pressure. Any relief stemming from the summit is therefore likely to be temporary.

Judging from its current account the Euro area as *a whole* is self-financing...



CA data for 2011Q4, NIIP for 2011 but 2010 for the US
Source: ECB,BoJ,ONS,BEA, GS Global ECS Research

...and *consolidated* public finances compare well to other economies



Source: GS Global ECS Research

EU summit: Resolution to remain elusive

EU leaders will meet in Brussels on June 28-29. Their summit has been billed as an opportunity to resolve the ongoing Euro crisis. Expectations have been raised.

We have been here several times before. The succession of EU summits held through the second half of 2011 saw each labelled the 'last chance to save the Euro'. Yet, with the benefit of hindsight, these summits can be viewed—at best—as part of an extended (and still incomplete) process of cumulative reform to address the crisis. A less favourable characterisation sees them as 'muddling through', offering little substantial progress towards crisis resolution but rather temporary sticking plasters to avoid the Euro's demise. With this experience in mind, thus far we have been sceptical of the prospects for end-June[1].

At the summit, we expect the heavily flagged growth compact to be finally fleshed out, facilitating the ratification of the fiscal compact and the European Stability Mechanism (ESM, financial bail-out fund). We also anticipate the announcement of a banking union plan (embodying pan-Euro area financial supervision, deposit insurance, bank resolution and recapitalisation fund)—even if not all elements can be made concrete immediately. Indeed, details are likely to remain sketchy, as substantial disagreement persists over key aspects of the proposal, notably as to how financial burdens will be distributed across countries. And the prospect of further financial support for troubled sovereigns, notably via the EFSF/ESM, has been raised, in response to persistent tensions in peripheral bond markets. As Francesco Garzarelli has recently argued[2], such mechanisms entail risks and are thus likely to remain controversial.

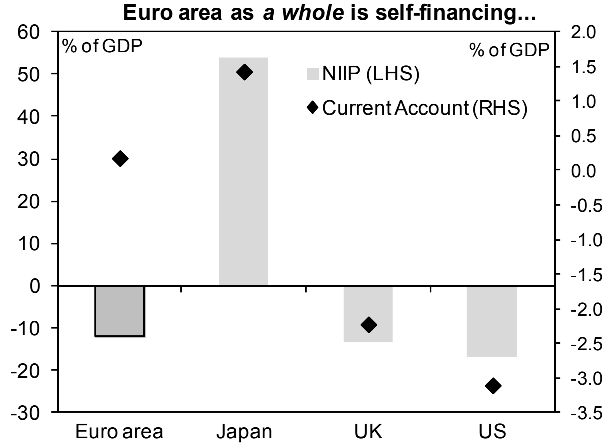
If their design can be optimised, each of these elements could, of itself, represent a step forward. Cumulatively, they may constitute a reasonably substantial package. And they have to be seen in the context of earlier innovations, such as the creation of the ESM and the fiscal compact. But realism dictates that the summit is unlikely to produce the 'quantum leap' in Euro area governance required to shift to a new, more stable and workable Euro area regime. While EU leaders may aim to articulate their vision of what that new regime will look like as an anchor for market and public expectations, the credibility of any such vision will be low, given past missteps and ongoing disagreements. In short, crisis resolution is likely to remain elusive.

Problem is weak governance

To set the stage, we recall some features of the consolidated Euro area economy:

- As regards the balance of payments, the Euro area's current account is broadly balanced and its external indebtedness is modest (see Chart 1). By implication, the Euro area economy as a whole is essentially self-financing.

Chart 1: Judging from its current account the Euro area as *a whole* is self-financing...



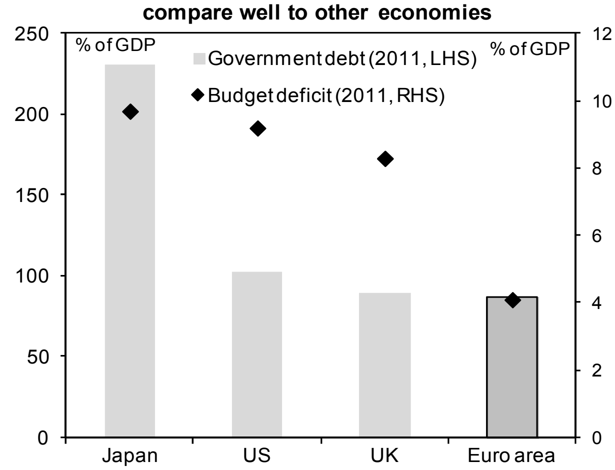
CA data for 2011Q4, NIIP for 2011 but 2010 for the US
Source: ECB,BoJ,ONS,BEA, GS Global ECS Research

- Turning to the public finances, on a consolidated basis the Euro area fiscal deficit is 4% of GDP, while the outstanding stock of public debt is slightly below 90%. While poor in themselves (e.g., they fail to meet the Maastricht convergence criteria), these figures are, in general, better than those observed in the other advanced economies (see Chart 2).

- While undoubtedly weak, the outlook for area-wide economic activity is (on the basis of our forecasts, market consensus and the international institutions) far from catastrophic. Weakness in the periphery is offset by relative strength in the core, especially in Germany.

Of course, the consolidated data discussed above represent a statistical artefact, not economic or political reality. Even just among the 'Big 4' Euro area states considerable cross-country heterogeneity exists. Thus, as we have argued in the past, the Euro area needs to correct

Chart 2: ...and *consolidated* public finances compare well to other economies



Source: GS Global ECS Research

1. See *European Economics Daily*: 'Key dates for the Euro area in the coming weeks–Expect to be disappointed', June 7, 2012.
2. See *Global Market Views*: 'What to Make of ESM Bond Purchase Suggestions', June 21, 2012.

its internal economic and fiscal imbalances[3]. In doing so, the Euro area does not require help from outside. The necessary resources are available in the Euro area, albeit not necessarily in the country where the need is acute.

The central and immediate challenge—and thus the one on which the outcome of the June EU summit should be judged—is therefore to develop a credible Euro area-wide framework so as to ensure that existing resources reach the right place at the right time. As experience during the financial crisis has demonstrated, within the weak governance structure of the Euro area, this is easier said than done. Reforming that governance is therefore the key to finding resolution.

What we can expect to emerge from the summit

1. Growth compact. We expect the finalisation of the so-called growth compact, characterised as a complement to the fiscal compact agreed last November. Key elements will be:

- *Infrastructure investment*, financed through a combination of: (a) more efficient use of existing EU structural funds; (b) issuance of 'project bonds' (which have a joint and several character across Euro area states, but are limited in size and scope); and (c) expansion of the European Investment Bank's capital.

- *Structural reform*, restating and renewing the established reform agenda across the Euro area and, in particular, in the peripheral economies undergoing adjustment.

These announcements have been widely flagged and will not represent news to the financial markets. While helpful at the margin, we are sceptical that they are game changers in an economic sense—however politically valuable they may prove as a concrete symbol of a shift towards a more growth-oriented agenda. The magnitudes involved, compounded by the practical difficulties in raising funds and identifying capital projects quickly, render these schemes relatively ineffective as a macro stabilisation tool in the countries facing immediate economic contractions, notably Spain and Greece.

At the same time, the ratification process for some of the new Euro area institutional machinery agreed at previous summits will be facilitated by the finalisation of the growth compact, allowing the process to be concluded over the summer.

2. Banking union. Prompted by the markets' adverse response to the announcement of EFSF loans to finance the Spanish government's bank recapitalisation, discussion of deeper integration in the financial sphere—labelled 'banking union'—has proceeded apace in recent weeks. The ECB has been a driver of these discussions.

We expect the announcement of a plan for banking union to be made at the summit. This much has been promised by Messrs. Barroso and Draghi. But, to be clear from the outset, we are sceptical that much concrete can be delivered by end-June: disagreement persists on crucial issues—not least the distribution across countries of financial liability for the fiscal underwriting of the Euro area banking system. These are not issues that can easily be glossed over. The credibility of any plan will suffer as a result of any such disagreement. And thus the announcement of a plan for banking union is unlikely to be a game changer and/or overcome current market tensions.

Four critical elements of a banking union are:

- *Pan-Euro area bank regulation and supervision*. Attention here has focused on the largest cross-border institutions. We expect an announcement that supervision will be transferred to the ECB, an institution enjoying the credibility and independence to mark a substantial regime change from existing arrangements. As such, such an announcement is likely to be viewed positively.

- *Pan-Euro area bank recapitalisation fund / bad bank*. Recent experience in Spain has demonstrated how attempts to recapitalise banks using public funds can backfire if they have adverse consequences for government finances. Allowing direct capital injections into suspect banks by Euro area-wide financing vehicles (EFSF/ESM) would overcome this problem, representing a significant step forward in the cross-border sharing of financial risks. While we expect policymakers to announce their intention to explore this route further, we do not expect definitive decisions at the summit: opposition from Germany remains strong.

- *Pan-Euro area bank resolution mechanism*. The quid pro quo for reassigning responsibility for bank recapitalisation to the Euro area-level is a similar re-assignment of responsibility for bank resolution to that level, thereby retaining the unity of financing provision and control that is seen by the German constituency (in particular) as crucial in avoiding the creation of moral hazard. The Commission has recently published proposals for establishing an EU bank resolution framework (albeit only by 2018): we expect some refinement and acceleration of this in the wider context of banking union.

- *Pan-Euro area deposit insurance*. Harmonisation of deposit guarantees was intensified following the collapse of Lehman, on the basis of European experience in the aftermath of that episode. But an open issue remains whether the fiscal backing for deposit guarantees should be established on a cross-border basis, so as to provide uniform insurance independent of the location of deposits within the Euro area. While the summit is likely to propose further exploration of the issue, firm proposals are unlikely to

3. See *European Economics Analyst* 12/01-04: 'Achieving fiscal and external balance (Parts 1-4)'.

emerge, not least because of the possible constitutional implications of any unlimited cross-border guarantees being offered in the German case.

Breaking the link between sovereign and bank crises is a crucial component of crisis resolution. Banking union represents a significant step in that direction. But we have to be realistic as to what can be achieved at the June summit. To be effective and credible, the key elements outlined above have to be legally sound. Ensuring clarity requires that legal instruments (directives and regulations) be drafted, approved and implemented; this cannot happen overnight.

Moreover, one needs to recognise the limits of some of these measures. In our eyes, banking union is an important component of a new, more workable and better functioning Euro area[4]. But it is not a solution to immediate market pressures and challenges. To illustrate: a pan-Euro area deposit insurance scheme may help stabilise European banks in the future, but in our view it is unlikely to halt a deposit run that could stem from the threat of Euro exit and redenomination. In such circumstances (which, to emphasise, are not our base case), the credibility of a promise to guarantee the par value of a Euro deposit in a bank of a country that has left the Euro area—possibly in acrimonious circumstances and associated with a repudiation of other obligations—is low. It is simply not politically feasible for the guarantor to deliver in those circumstances[5].

While welcoming the articulation of a roadmap to banking union, we remain cautious. Delivery and implementation will remain crucial: this is where the European authorities have failed to deliver in the past. One place where more rapid action is possible concerns the transfer of supervisory responsibilities to the ECB. The Lisbon Treaty establishes a special procedure for such a transfer, which could be activated quickly[6]. While such a transfer would—in itself—not mark a fundamental change to the financial outlook, this concrete and verifiable step, coming as it does with an explicit cost to national authorities in terms of loss of sovereignty, could represent a clearer signal to financial markets of governments' political commitment to further integration and resolving the Euro crisis. After all, we have argued in the past that an important hindrance to resolution was reluctance, particularly on the French side, to relinquish sovereignty in this way[7].

3. Articulating a vision for the Euro area. Beyond the domain of banking union, we expect the EU leaders to use the summit as a platform to set out a broader vision for the Euro area in its new regime. The ambition to do so is admirable. In principle, such an initiative can help to: (a) stabilise market expectations, by offering an anchor that pins down the end-game; and (b) stabilise the political situation, by presenting a positive longer-term goal that justifies the considerable shorter-term adjustment costs that are currently being paid, especially in the periphery. Greater fiscal and political integration would represent the cornerstones of this vision.

Unfortunately, the effectiveness of any such articulation hinges largely on its credibility. We are sceptical of the EU leaders' ability to deliver on this score. Not only has their credibility been undermined by missteps in the past, but divisions among leaders and their countries also remain painfully apparent, rendering it impossible to present a unified, coherent and thus credible view. Most notably, Germany and France continue to have different conceptions of what 'political union' and 'fiscal union' entail, as well as how the two interact with one another.

For all the good intentions underlying an attempt to set out a longer-term goal on which the Euro area should converge, in our view taking more concrete steps to address immediate challenges effectively is more important. It is through delivering in this way that credibility and momentum can be re-established. Only once that point is reached will announcements about the future have an impact. Meanwhile, in the absence of a credible positive goal, maintaining political support for the Euro and the measures needed to sustain it will become more challenging, especially in peripheral economies suffering recession.

4. Containing market pressures, one way or another via the ECB. This brings us to the issue of what the EU leaders can deliver to contain the intense market pressure on Spanish sovereign funding, which already threatens to spill over into Italy and intensify broader Euro area systemic risks.

In the margins of the G-20 meeting earlier this week, speculation has been rife that the EFSF / ESM will commence larger-scale purchases of Italian and Spanish government debt. And many old proposals—such as giving the ESM a banking licence so that it can access ECB facilities or establishing target zones for sovereign bond spreads—have been revived. In assessing the various statements emerging from European officials on these issues (both on and off the record), one has to recognise the complicated game being played among the various parties: market pressure is manipulated to build bargaining power—an unedifying dynamic that does little to stabilise the market situation.

We have argued that, despite its obvious and understandable reluctance to be drawn further into the fiscal domain, the ECB is likely to come under pressure to act to contain market pressures in one way or another,

4. See *European Weekly Analyst*: 11/30 'Next steps for the Euro area—A primer' .
5. See *European Economics Daily*: 'Meeting deposit runs in the Euro area', 23 May 2012 .
6. The Lisbon Treaty (Art. 127 (6)) states: "The Council, acting by means of regulations in accordance with a special legislative procedure, may unanimously, and after consulting the European Parliament and the European Central Bank, confer specific tasks upon the European Central Bank concerning policies relating to the prudential supervision of credit institutions and other financial institutions ..."
7. See *European Weekly Analyst:* 12/01 'Year ahead in the Euro area—Four things to watch'.

with a further 3-year LTRO and/or a further expansion of the definition of collateral eligible for ECB operations (or redefinition of haircut schedule) possible first steps. Implicitly, sharing across the Euro area of the liquidity and credit risks implicit in the periphery's significant debt overhang will take place across the Eurosystem balance sheet, financed by a further expansion of TARGET 2 balances (and thus money creation). *Plus ça change, plus c'est la même chose.*

Progress on some of the issues described above, notably concrete steps towards banking union which the ECB holds dear, may offer a pretext for the ECB to assume a more active role. But, as in the past, financial support from the ECB via conduits such as domestic banks and/or EFSF/ESM—even if it is initially well-received by the market—does not represent a solution to the Euro area's fundamental problems.

Adjustment with European characteristics

Summing up, we doubt that the June summit will be sufficient to address the institutional and governance weaknesses that we identify as the fundamental cause of the Euro's malaise. What then for the Euro area? And how does the summit fit into the ongoing and evolving crisis?

The Long March. One characterisation of the June EU summit is as another step forward in a long and slow process of necessary adjustment and governance reform in the Euro area. In this context, banking union is seen, for good reason, as a crucial element of the new institutional architecture required to make the Euro area a workable economic entity. But alone it is not enough: it represents a necessary, but far from sufficient, component of the new Euro regime.

Only when taken together with other institutional innovations would we expect the outline of a more politically and fiscally integrated economic union to emerge. In this view, the impact of ESM expansion, fiscal compact, banking union and further individually modest steps to be undertaken in future eventually cumulates in a manner initially underappreciated by the markets but ultimately sufficient to underpin the currency.

In this scenario, measures to contain immediate market pressure represent nothing more than 'muddling through'. But such muddling through, however inelegant, serves a higher purpose: buying time for the succession of small steps forwards to build its cumulative stabilising effect.

The Great Leap Forward. Critiques of the preceding 'long march' scenario centre around scepticism that market pressure can be contained. In an alternative scenario, decisive steps forward are taken more rapidly. In principle, far-sighted political leadership could be the driver of such action. More realistically, intensifying market pressure forces Spain towards a de facto EU programme, as market access is denied. The additional fiscal demands this implies on the rest of the Euro area weaken the public finances of Italy: via a domino effect, pressure is quickly brought to bear on France and ultimately Germany.

Relying on a slow, cumulative improvement in governance is inadequate in these circumstances. The 'Big 4' countries would quickly be presented with the question of whether they are prepared to take the steps necessary to underpin the Euro or not. Measures would need to be taken rapidly and aggressively: it would be necessary to act outside the existing institutional framework. Germany and France would have to decide whether they are prepared to take a 'great leap forward' in terms of economic and political integration in order to preserve the Euro. Muddling through would no longer suffice. And a refusal to take that step is likely to lead to the breakup of Euro area and possible demise of the Euro.

What probabilities do we assign to these scenarios? The revealed preference of Euro area politicians is to prevaricate for as long as possible. As a consequence, we expect to continue along the 'long march' for now. The June summit will not change that trajectory: we see the possibility that far-sighted leadership takes a great leap forward as very low.

But the threat of intensifying market dislocation hangs over us. Politicians' hands are likely to be forced, as Spain (through one channel or another) becomes more reliant on official external financial support, triggering the toppling of fiscal dominoes via Italy to France. So we see a halt to the 'long march' as highly likely, prompting need for a decision on whether to make the leap forward.

From a market perspective, the key questions are therefore: (a) the timing of this switch; and (b) the choices made by the key players at that point.

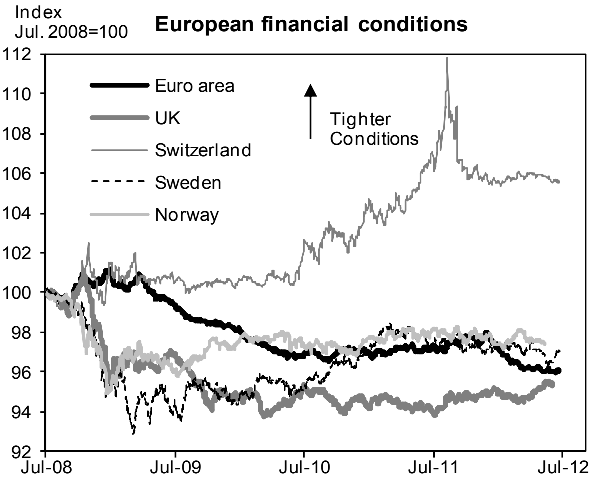
- As regards the latter, we continue to believe that France and Germany will ultimately take the necessary steps, although we recognise that the probability of a failure to do so, while still modest, is growing.
- The former question is more difficult. While the French government bond market continues to be supported by the ample liquidity created by the ECB's 3-year LTRO operations, France remains insulated to a large extent from financial disruptions in the periphery. And the scope to maintain the status quo via ECB action remains considerable. Our central case thus remains that this forcing mechanism will not take hold until next year.

Huw Pill

Key European Indicators

European financial conditions are easy, with the exception of Switzerland.

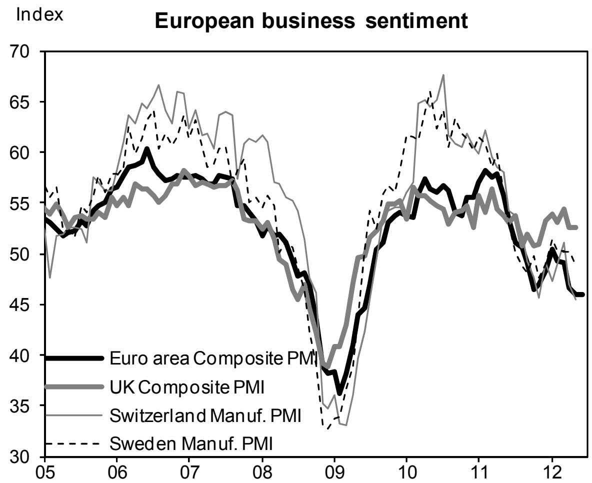
European financial conditions



Source: GS Global ECS Research

Business sentiment deteriorates across Europe.

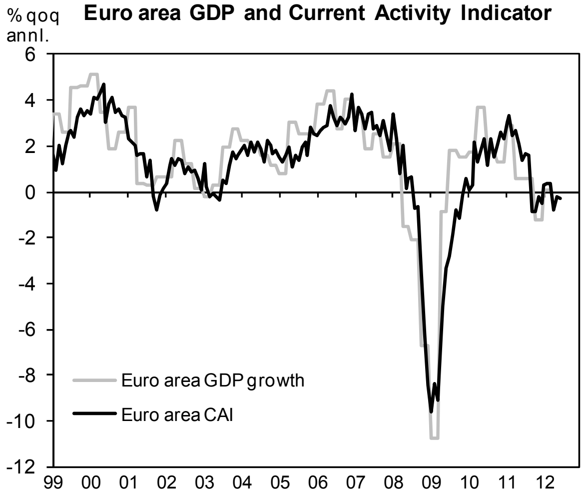
European business sentiment



Source: Markit, SVME, Swedbank, GS Global ECS Research

Our Euro area Current Activity Indicator points to a contraction of around 0.3%qoq annualised...

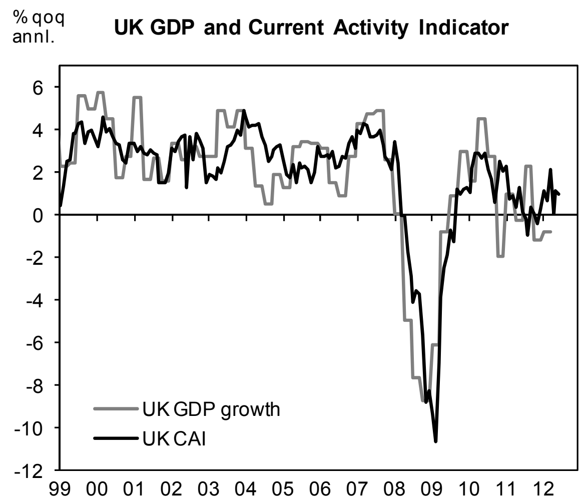
Euro area GDP and Current Activity Indicator



Source: GS Global ECS Research

...and our UK Current Activity Indicator is consistent with growth of around 1.0%qoq annualised.

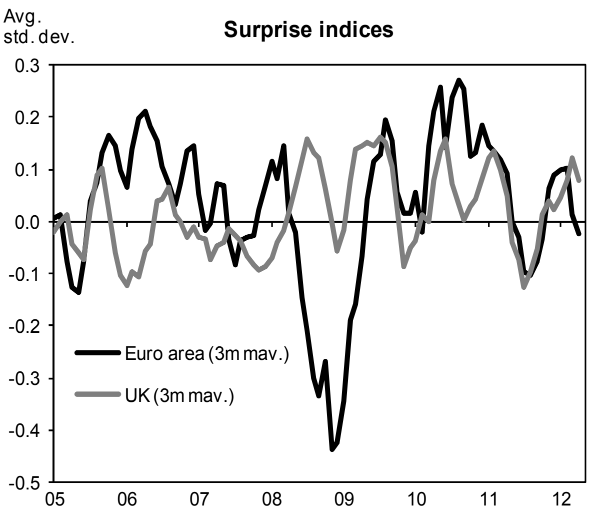
UK GDP and Current Activity Indicator



Source: GS Global ECS Research

Data releases have surprised on the upside in recent months in the UK but on the downside in the Euro area.

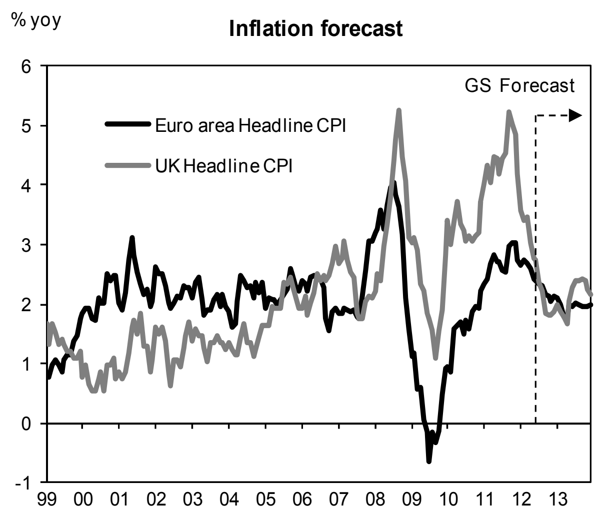
Surprise indices



Source: GS Global ECS Research

We expect a significant convergence in Euro area and UK inflation, to rates below 2% in early 2013.

Inflation forecast



Source: Eurostat, ONS, GS Global ECS Research

Main Economic Forecasts

	GDP (Annual % change)			Consumer Prices (Annual % change)			Current Account (% of GDP)			Budget Balance (% of GDP)		
	2011	2012(f)	2013(f)	2011	2012(f)	2013(f)	2011 (f)	2012(f)	2013(f)	2011(f)	2012(f)	2013(f)
Euro area	1.5	-0.5	0.4	2.7	2.4	1.9	-0.3	-0.1	-0.1	-4.1	-4.0	-3.2
Germany	3.1	0.9	1.3	2.5	2.3	2.0	5.7	4.3	3.9	-1.0	-1.0	-0.7
France	1.7	0.2	0.9	2.3	2.2	1.8	-2.2	-2.0	-1.8	-5.2	-4.8	-4.0
Italy	0.5	-1.9	-0.4	2.9	3.2	2.3	-3.2	-1.5	-1.4	-3.9	-3.2	-2.2
Spain	0.7	-1.4	-1.2	3.1	1.9	1.7	-3.5	-3.1	-2.5	-8.9	-6.7	-5.9
UK	0.7	0.6	2.3	4.5	3.0	2.1	-1.9	-1.2	-0.9	-8.1	-5.7	-5.9
Switzerland	2.1	1.2	1.1	0.2	0.4	0.7	16.0	14.7	14.5	-0.3	-0.2	-0.1
Sweden	4.0	1.4	2.4	2.6	2.0	2.2	7.2	7.2	7.0	0.3	0.4	0.8
Denmark	1.0	0.2	1.2	2.7	2.2	1.6	5.6	5.5	3.9	-3.5	-4.6	-4.3
Norway*	2.7	2.3	2.5	1.3	1.2	1.6	14.6	15.0	15.0	-	-	-
Poland	4.3	2.5	3.3	4.3	4.1	2.7	-4.1	-4.2	-4.4	-5.1	-3.2	-2.8
Czech Republic	1.7	0.6	2.5	1.9	3.3	1.0	-2.5	-2.5	-2.6	-3.9	-3.0	-2.8
Hungary	1.7	-1.5	1.7	3.9	6.2	4.5	1.4	1.4	0.9	1.5	-3.5	-3.0

*Mainland GDP growth.

Source: GS Global ECS Research.

I, Huw Pill, hereby certify that all of the views expressed in this report accurately reflect my personal views, which have not been influenced by considerations of the firm's business or client relationships.

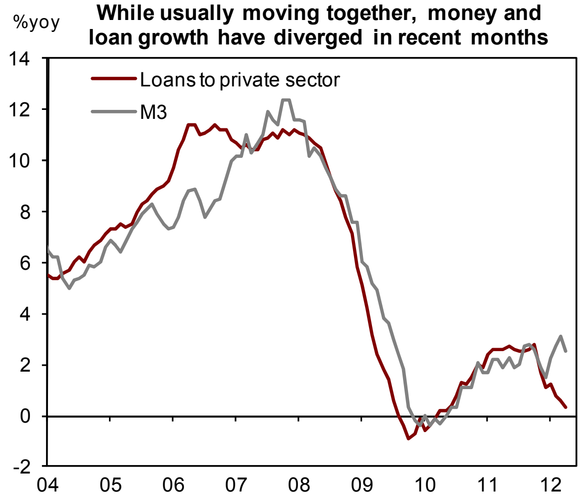
Focus for the Week Ahead

June **Euro area Flash CPI inflation** will be published on Friday. We expect an unchanged reading of +2.4%yoy following last month's 20bp decline.

The Euro area **monetary and credit** data for May are also due on Friday. It will be interesting to see whether the expansion of loans to the private sector seen in April will continue in May, especially given this was the first meaningful increase since the sharp contraction in December. The data will also give us a better sense of the effectiveness of the ECB's recent non-standard measures.

On the policy front, **EU leaders will meet** on Thursday and Friday. At the summit, we expect to see the finalisation of the growth compact and the announcement of a plan for 'banking union' in the Euro area (see this week's focus piece). However, we do not expect a comprehensive resolution of the governance issues affecting the common currency area. This is a key element of stabilisation.

Outside the Euro area, the key release is the Swiss **KOF Leading Indicator** for June. We expect a broadly unchanged reading.



Source: ECB, GS Global ECS Research

Economic Releases and Other Events

Country	Time (UK)	Economic Statistic/Indicator	Period	Forecast* mom/qoq	Forecast* yoy	Previous mom/qoq	Previous yoy	EMEA-MAP Relevance
Fri 22nd June								
Italy	09:00	Consumer Confidence	Jun	—	—	86.5	—	1
Germany	09:00	IFO Business Survey	Jun	—	—	106.9	—	3
Mon 25th June								
—	—	—	—	—	—	—	—	—
Tues 26th June								
France	07:45	Consumer Confidence	Jun	—	—	90.0	—	3
UK	09:30	PSNB (nsa)	May	+£9bn (exc)	—	–£16.5bn (exc)	—	—
UK	09:30	PSNCR (nsa)	May	+£5bn	—	–£23.2bn	—	—
Wed 27th June								
Germany	—	German States CPI	Jun	—	—	—	—	—
Italy	09:00	Business Confidence	Jun	—	—	86.2	—	4
UK	09:30	CBI Distributive Trades Survey	Jun	—	—	21.0	—	—
Germany	13:00	Harmonised CPI	Jun	—	—	—	+2.2%	—
Thurs 28th June								
Spain	08:00	Harmonised CPI	Jun	—	—	—	+1.9%	—
Sweden	08:30	Retail Sales	May	—	—	–0.2%	+0.8%	3
Germany	08:55	Unemployment (Change)	Jun	—	—	0K	—	2
Norway	09:00	Unemployment Rate	June	—	—	+2.3%	—	4
UK	09:30	GDP	Q1(Revised)	–0.3%	–0.1%	–0.3%	–0.1%	4
Italy	10:00	Harmonised CPI	Jun	—	—	—	+3.5%	—
Fri 29th June								
UK	00:01	GFK Consumer Confidence	Jun	—	—	–29	—	—
France	07:45	Consumer Spending	May	—	—	+0.6% mom	+0.4%	2
Switzerland	08:00	KOF Leading Indicator	June	—	—	0.8	—	4
Norway	09:00	Retail Sales	May	—	—	–0.1%	–3.7%	2
Euro area	09:00	M3 - YoY % Change	May	—	—	—	+2.5%	0
Euro area	10:00	Harmonised CPI	Jun	—	+2.4%	—	+2.4%	—

Source: Bloomberg, GS Global ECS Research. Economic data releases are subject to change at short notice in calendar. Complete calendar available via the Portal — https://360.gs.com/gs/portal/events/econevents/. * In the case of the PMIs, the Forecast is simply the Flash estimate where available (Flash PMIs are published by Markit for the Euro area, Germany and France 1-2 weeks before the end of the reference month).