A Nascent Growth Pact is Beginning to Take Shape

The agenda in the euro zone is changing. The likely outcome of the weekend elections in Greece and France are just as much an effect as a cause of the shift in the agenda. For the first time since the crisis began, the German insistence on austerity is being complemented by the push for a growth pact. We recognized ECB President Draghi's endorsement of this as being a significant catalyst.

It is not simply that the euro zone economy as a whole is contracting, but it is also that the political backlash against more austerity is growing and producing greater political instability. Consider what is likely to happen in France. It is not simply that a Socialist is likely to be elected to the French presidency, something that has only happened twice (Mitterrand both times) since the end of World War II, but the anti-EU Le Pen Party is likely to secure parliamentary representation in the National Assembly in the June elections for the first time since 1986.

Over the past ten days or so, two European governments have collapsed over the implementation of austerity--the Netherlands and Romania. In addition, at least two countries in the euro zone have now formally indicated they will miss their fiscal targets this year--Spain and Italy. Press reports suggest that after the election, Greece's 2012 fiscal target may be relaxed a bit. With weaker growth prospects and higher unemployment, it is possible that other countries also miss this year's fiscal targets.

With France's Hollande "promising" to renegotiate the fiscal compact, it is hardly surprising that the latest polls from Ireland show less than a majority of voters now support the compact. Ireland holds its referendum at the end of next month. Given the qualified majority voting, a rejection by Ireland will not itself sink the treaty, but rather would deny Ireland access to ESM funds, should they be needed.

We note as an aside the press reports indicating that Greece is looking to inject about 250 mln euros into the electrical utility sector. It appears the reform to collect new property taxes through the electric company has led to a "strike", leaving the electric bills unpaid and triggering liquidity crunch at the utility.

Neither France's Sarkozy nor Italy's Monti are sufficiently unencumbered to make the decisive pitch for a growth compact. This is part of the reason the ECB's Draghi had to do so, if it were to be done. Germany's Merkel, recognizing changing political winds, quickly endorsed the concept. As Germany has done through the crisis, with varying degrees of insistence, Merkel seemed to favor largely supply-side structural reforms to lift potential growth rates.

However, others in Europe are reportedly focusing on an aspect notably absent from Germany's version – namely, new funds. The European Investment Bank (EIB) appears to be at the center of the new thinking. In particular, reports suggest that an investment program of as much as 200 bln euros is being considered. Infrastructure projects, renewable energy, and technology sectors will be earmarked, especially in the countries worst hit by the debt crisis.

Some of the early proponents suggest that the EIB may be able to tap into some funds from the EFSF (a Spanish newspaper report suggested around 12 bln euros). The precise structure has yet to be worked out, but there is some talk that the EU is exploring ways in which the EIB's loan portfolio may be securitized. One proposal is for the EIB to guarantee the issuance of bonds backed by the assets of the investment projects themselves.

Admittedly, both are needed: Structural reforms to increase the capacity to grow and new investment to finance the growth, as the key question remains of where aggregate demand is going to arise when governments and households are de-leveraging.

Spain's Rajoy continues to unveil reforms; most recently in terms of education and health care. Italy's Monti announced far-reaching structural reforms last week that appeared to be largely overlooked. In essence, Monti moved to weaken the seemingly incestuous corporate culture in Italy by diluting cross-shareholding. Specifically, Monti banned executives from holding a board seat in more than one financial institution operating in the same market.

The government's move was supported by the Bank of Italy, which has for several years expressed discomfort with the extent of this practice, which it argues is a risk to financial stability, stifles competition and introduces systemic rigidities. There have been reports suggesting that as many as 1500 board seats may be impacted by this reform that went into effect last week.

The important take away is that the austerity agenda in Europe may have run as far as it can, given the political instability/backlash that it is sparking. What a growth pact entails is far from clear, but the initial talk of reinvigorating the European Investment Bank seems promising. Yet it comes too late to stabilize the political climate ahead of the weekend elections, next month's two German state elections, the Italian municipal elections and the Irish referendum, and the June parliamentary elections in France.

Marc Chandler

Global Currency Strategy Team

Marc Chandler | Global Head of Currency Strategy | 1.212.493.8800 | marc.chandler@bbh.com

Win Thin | Global Head of Emerging Market Currency Strategy | 1.212.493.8867 | win.thin@bbh.com
Mark McCormick | Currency Strategist | 1.212.493.8744 | mark.mccormick@bbh.com

Ilan Solot | Currency Strategist | 44.20.7614.8747 | ilan.solot@bbh.com
Masashi Murata | Currency Strategist | 011.813.6361.6328 | masashi.murata@bbh.com