

## Parry and Feint: Outlines of Europe's Next Chapter

European officials have reached an agreement in principle that falls well shy of the “comprehensive plan” officials had promised and is unlikely to provide investors with a sense of closure to the debt crisis that began in late 2009. Yet progress was sufficient that the debt crisis is unlikely to override the divergence of US and European interest rate policy as the main driver in the euro-dollar exchange rate.

Ironically, Greece, which had acknowledged just as the summit was beginning that its budget deficit was about 9% wider in the Jan-Feb period compared with year ago levels, was the biggest winner from the agreement in principle that requires an EU vote at the March 24-25 summit.

Officials agreed to increase the efficiency and flexibility of the European Financial Stabilization Facility (EFSF). In order to maintain a triple-A rating, the EFSF had to have greater guarantees than loans and had to establish a cash buffer. This reduced the effective amount that EFSF could loan to about 250 bln euros, almost half what was initially envisioned. Increased efficiency refers to how much it can lend and an agreement was reached to bring the lending amount up to 440 bln euros.

The increased flexibility is a surprise. This relates to its functionality. In the Irish case, it sold bonds to raise funds and then lent most of those funds to Ireland at about 200 bp more than it cost. The new agreement allows the EFSF to buy bonds directly from the governments, provided that the governments are already in an assistance program with strict conditionality.

To be clear, the EFSF cannot buy bonds in the secondary market or from third parties (including the ECB). This is somewhat narrower than the EU and ECB advocated, but probably too much for those fearful that a transfer union is to emerge to compliment the monetary union. Buying bonds directly from such governments (Greece and Ireland are the only two candidates presently) is tantamount to a direct loan, which is expressly prohibited. The German Constitutional Court will likely have to weigh in.

The EFSF works on the basis of guarantees. The guarantees do not count as the debt for the contributing countries until it actually issues bonds. If the EFSF were to buy Greek and/or Irish bonds, this would boost the debt measures of countries, including Germany and France, but also Italy and Spain. The rating agencies have indicated they will monitor these developments.

Greece also won another concession. The terms of the current aid package were relaxed. The interest rate being charged on the European share of the assistance will be cut by around 100 bp to about 4.25% and the duration has been more than doubled to 7 ½ years from 3.

Ireland did not get the same deal. Germany, and especially France, had demanded that Ireland make some concession on its low 12.5% corporate tax rate, which has long been a bone of contention. Irish Prime Minister Kenny who had only been in office three days refused to compromise. This reportedly provided quite heated debate.

Ireland has a couple of cards that can be played. The broad agreement faces an EU vote where unanimity is required. By rejecting the agreement Ireland could scuttle, or at least throw into disarray, this reform effort. Perhaps the ultimate trump

card is reneging on the promise of the previous government to treat senior secured bank bond holders as depositors and guarantee them in full.

Reports indicate some Irish officials and the IMF are sympathetic to such a course, but the EU and ECB are fiercely opposed. Their concerns are couched in systemic terms. If Ireland's guarantee is not really a guarantee, the fear is that all of the sovereign guarantees will be questioned. It seems like this fear is exaggerated. A few words from German or French, Dutch, Spanish and Italian officials saying that the Irish decision was unfortunate but would not affect their policy would likely suffice to quash any budding doubts.

Nevertheless, it begs the question of who are these creditors that the EU and ECB are insisting should be spared any burden sharing, unlike all other stakeholders. Ultimately private sector banks are the largest creditors of Ireland and the other peripheral countries. European officials fear a new banking crisis, not in Ireland, but in Germany, France and elsewhere. It is demanded and Ireland and Greece take on more debt so that their primarily European creditors can remain whole.

In exchange for agreeing to greater flexibility and firepower of the rescue funds, Germany (and France) wanted members to agree to a "competitive pact". This met stiff resistance and European Union President Van Rompuy and European Commission Barosso filled the breach and offer a diluted "euro pact". There appeared to be some agreement to enshrine into national law the principle of fiscal rectitude.

While Germany's Merkel said this paved way for the broader agreement, the situation is more complicated. Members have already agreed to the Stability and Growth Pact, which specifies caps on deficit and debt levels. It is not as some of the critics suggest closing the barn door after the horses have bolted, but rather it is a case of bearing braces and a belt. If the Stability and Growth Pact pledges did not work, will repeating them and making new pledges be any more effective?

Contrary to what is often claimed, fiscal profligacy did not cause the crisis in the periphery, except perhaps in Greece. Ireland's woes begin only when the country, at the urging of European officials, made private debts public and on a scale that was much larger than Irish officials were led to believe.

The larger deficits experienced throughout much of the euro zone are a function of the loss of revenue and increased countercyclical spending associated with economic contractions. The historical record shows that the first exceptions to the Stability and Growth Pact were Germany and France themselves and then they conveniently voted against fining each other. Other parts of the Paris-Berlin "competitive pact" were also successfully diluted in substance and enforcement. Despite the pressure brought to bear on Ireland, no harmonized corporate tax rate was agreed up. Greece scored another victory in that demand for a common retirement age was also not mandated. Nor was the abolition of wage indexing agreed upon. Instead, members made vague promises to more closely harmonize budgetary, tax and social policies.

The agreement has hardly the makings of the comprehensive plan officials had promised. One of the only reasons Merkel will can be considered victorious is the bar has been lowered by a series of recent setbacks including losing the leading candidate for ECB head, an embarrassing resignation of her charismatic foreign minister and a terrible electoral showing in Hamburg (even if local issues dominated). Merkel did not previously appear in favor of the EFSF or ESM buying sovereign bonds. Is it too cynical to suspect the Merkel is hoping the Constitutional Court prevents this and she can shrug her shoulders and say she tried?

Trichet cannot be very pleased with these results. He damned it with faint praise: "a step in the right direction", he was quoted as saying. He called for bold action and got milquetoast. If anything, this can only increase the risk that the ECB hikes rates in a few weeks. There is no relief to the ECB self-appointed task of buying sovereign bonds to preserve what it has said

is the transmission mechanism of monetary policy. The ECB's bond buying has not prevented a continued rise in Greek, Irish and Portuguese interest rates. In addition, in recent days the firewall around Spain and Italy has come under additional stress. Portugal remains on the bubble. The new savings (0.8% of GDP) announced on the eve of the summit were broadly welcomed and endorsed by officials. Judging from the performance of Portuguese bonds and credit default swaps, the market is not convinced it will avoid seeking assistance. With these latest efforts, Portugal could negotiate for terms along the lines of Greece, rather than Ireland. Portuguese officials must be pleased to learn that there is some move to bring the EFSF and later the ESM's lending rate more in line with the IMF.

Portugal has grown by an average rate of less 1% a year over the past decade. The central bank forecasts a 1.3% economic contraction this year. The pro-cyclical nature of its fiscal policy warns of downside risks to this forecast. An assistance program is still the most likely scenario.

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