

The latest euro deal

Businesses beware - there will be costs for years to come



The deal was announced shortly before dawn on October 27th. The markets approved when they opened a few hours later. The euro's value jumped and equities rallied.

Although promoted as a "comprehensive" set of measures to save the euro (and the third one so far this year), the deal was nothing of the sort. The eurozone's leaders had carefully concerned themselves with just the medium-term financing conditions for eurozone sovereign states and private banks.

This had three connected strands: reducing Greece's national debt, recapitalising (injecting new cash into) the eurozone's private banks to help them absorb the losses on Greek and other sources of debt, and creating a 'firewall' to protect other vulnerable but still solvent states, notably Italy.

The deal has successfully prevented a second credit crunch. A global recession would certainly have followed.

But the deal sidesteps the eurozone's core problems. A number of eurozone members face a low growth/high debt medium-term future. They need to deregulate their industries in order to improve competitiveness. And debt repayment will involve higher taxes, public sector job cuts and social security and pension reform.

More fundamentally, the eurozone is still not an optimal currency area. It does not have a lender of the last resort and cannot co-ordinate fiscal policy. This will leave the euro vulnerable to market risk-aversion if borrowing starts to rise again, or even if debt reduction stalls. Moreover, the eurozone is also solving debt problems with more debt. There chances of this course of action ending badly are very high.

Greece's deal

The eurozone's leaders have negotiated with the Institute of International Finance (which represents Europe's private banks) to reduce Greece's debt to private creditors to half the value of the bonds they hold. This comes to €80-€100 billion. In exchange, the banks will get €30 billion for the losses and €106 billion (on top of €109 billion already

promised in July) in recapitalisation funds.

No one is sure whether this constitutes a default. This reduction in the value of privately-held bonds is being termed "voluntary" in an attempt to sidestep the term "default".

The International Swaps and Derivatives Association will have its say. If it decides that a 'credit event' has taken place, then credit default swaps will come into play.

These are insurance contracts that holders of government bonds buy to protect themselves against sovereign defaults and not getting the full value of their bonds back.

The eurozone's leaders are determined to prevent holders of CDS contracts on Greek debt from claiming on their losses. But it is unclear which banks would be affected. The politician's fear is that if this liability is concentrated on a few banks, it could lead to a Lehman-style collapse.

If CDS holders are prevented from claiming on their contracts for Greek debt, then new problems will emerge. CDS insurance will be re-evaluated.

If they do not offer the level of risk-reduction that has been presumed, then investors will demand other hedge tools and the finance industry will supply them. Investors may also become more risk averse and expect higher yields to

compensate for the additional risk they perceive they are carrying.

Recapitalising the banks

The second strand of the rescue plan is a €106 billion injection for Europe's banking system. This is in anticipation of mass selling of Spanish and Italian bonds in secondary markets which will drive down their prices and reduce the asset values on banks' balance sheets.

Europe's banks will have to come up with this money as part of tougher, new Tier-1 regulations which demand a capital ratio of 9% by mid-2012. The value of government bond holdings will have to be recalculated by their September 30th values.

This will be tough on Spanish and Italian banks because their Spanish and Italian bonds have lost value, while British and German banks will be mostly unaffected. Suspicions have centred on the recalculation date. French bonds fell in value shortly thereafter and France is close to losing its AAA credit rating.

The flaw here is the potential impact on economic growth. The eurozone economy has struggled for growth this year and recession in early 2012 is a real possibility. In order to meet the Tier-1 rules, the privately held banks could just cut back on trade finance or small business investment

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over the next eight months. This would drag the eurozone deeper into recession. They could even sell their distressed government bonds, pushing their prices down even further and increasing the yields on new issues.

Protecting the sovereigns

This need to support the markets for Spanish and Italian bonds from contagion from Greece is where the €1 trillion fund comes in. The European Financial Stability Fund, backed up by €440 billion and a AAA credit rating, will only stretch to cover Greece, Portugal and Ireland.

Extending the EFSF is difficult - it is a liability on contributors, so their own credit positions would suffer. Instead, the eurozone leaders have promised some financial engineering (of the type many of them condemned as the credit crunch emerged in 2007) to expand the EFSF to a commanding €1 trillion.

There are several engineering options. One is for the EFSF to act as insurer of government bonds - effectively to replace CDSs. By offering to cover the first, say, 20% of losses, the EFSF could easily insure €1 trillion of government debt.

Another option is to use special purpose vehicles. Again, by guaranteeing the first of any sovereign losses, these could entice private investors or sovereign wealth funds from

emerging economies. SPVs would work very much like collateralised debt obligations, the debt tools which lost much of their appeal in the credit crunch.

Both options share a weakness - that the insurers credit-worthiness is correlated directly with the potential undesirable outcome (that the debt will not be repaid). A sovereign credit default in Europe would weaken the banking system (in which government's have already invested) and so reduce the ability of all governments to honour their obligations.

India and Russia have suggested another potential funding solution. They have expressed a preference for channelling any rescue funds through the IMF over any SPVs. This route would also allow the euro opt-outs (including the UK) to contribute to the solution without appearing to be throwing money directly into bail-outs.

Businesses beware

The eurozone's leaders seem only willing to commit to short-term, stop-gap solutions to the debt crisis. This is because the German and French leaders face elections in 2012 and have limited support for using their taxpayers' funds to help the debt-laden eurozone members on the periphery.

The debt crisis will persist in some form for a decade, and possibly longer. Debt repayment will mean lower eco-

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nomical growth. Resources will leave these economies as foreign bond holders are paid dividends and principal.

Debt repayment will also mean that Europe's capital markets will suffer almost perpetual turbulence. Investors could come to associate sovereign default risk with the broader economic risk of investing in the region. Europe's corporate sector could be saddled with higher borrowing costs as a result.

There will also be periods when sovereign funding requirements (as states roll their debt over) will drain Europe's banking system of liquidity, even with the help of the global banking system. Again, Europe's business debt markets will suffer.

The debt repayment required across the eurozone will inevitably mean public sector restructuring and job losses. Unemployment rates are likely to rise into the medium term.

It seems probable that Europe's businesses will be called upon to help finance this restructuring through higher corporation, social insurance and sales taxes. This will affect Europe's relative attraction for FDI and equity holdings. It could even provoke some corporation tax rate bidding if eurozone members become compelled to compete for FDI.

Finally, investors across the world have been surprised by the lack of response from the eurozone's leaders in dealing with a financial crisis of such magnitude. Investors will have noted that the eurozone lacks the institutions and reporting structure to deal with serious problems. Heads of state can be torn between eurozone objectives and domestic priorities.

Until the eurozone demonstrates that it has the political and financial mandates to coordinate and manage the eurozone's finances, investors will demand a premium for holding euro-denominated assets. These mandates will inevitably involve a fiscal policy brief. Faced with this prospect, the eurozone opt-outs will probably remain opt-outs for many years to come. ©

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