Europe’s rescue plan

This week’s summit was supposed to put an end to the euro crisis. It hasn’t

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YOU can understand the self-congratulation. In the early hours of October 27th, after marathon talks, the leaders of the euro zone agreed on a “comprehensive package” to dispel the crisis that has been plaguing the euro zone for almost two years. They boosted a fund designed to shore up the euro zone’s troubled sovereign borrowers, drafted a plan to restore Europe’s banks, radically cut Greece’s burden of debt, and set out some ways to put the governance of the euro on a proper footing. After a summer overshadowed by the threat of financial collapse, they had shown the markets who was boss. Yet in the light of day, the holes in the rescue plan are plain to see. The scheme is confused and unconvincing. Confused, because its financial engineering is too clever by half and vulnerable to unintended consequences. Unconvincing, because too many details are missing and the scheme at its core is not up to the job of safeguarding the euro. This is the euro zone’s third comprehensive package this year. It is unlikely to be its last.

Words are cheap…

The summit’s most notable achievement was to forge an agreement to write down the Greek debt held by the private sector by 50%. This newspaper has long argued for such a move. Yet an essential counterpart to the Greek writedown is a credible firewall around heavily indebted yet solvent borrowers such as Italy. That is the only way of restoring confidence and protecting European banks’ balance-sheets, thus ensuring that they can get on with the business of lending.

Unfortunately the euro zone’s firewall is the weakest part of the deal (see article). Europe’s main rescue fund, the European Financial Stability Facility (EFSF), does not have enough money to withstand a run on Italy and Spain. Germany and the European Central Bank (ECB) have ruled out the only source of unlimited support: the central bank itself. The euro zone’s northern creditor governments have refused to put more of their own money into the pot.

Instead they have come up with two schemes to stretch the EFSF. One is to use it to insure the first losses if any new bonds are written down. In theory, this means that the rescue fund’s power could be magnified several times. But in practice, such “credit enhancement” may not yield much. Bond markets may be suspicious of guarantees made by countries that would themselves be vulnerable if their over-indebted neighbours suffered turmoil.

Under the second scheme, the EFSF would create a set of special-purpose vehicles financed by other investors, including sovereign-wealth funds. Again, there are reasons to doubt whether this will work. Each vehicle seems to be dedicated to a single country, so risk is not spread. And why should China or Brazil invest a lot in them when Germany is holding back from putting in more money?

Together, these schemes are supposed to extend the value of the EFSF to €1 trillion ($1.4 trillion) or more. Sadly, that looks more like an aspiration than a prediction. And because the EFSF bears the first losses, its capital is at greater risk of being wiped out than under a loan programme. This could taint France, which finances the rescue fund and has recently seen its AAA credit rating come under threat. Since the EFSF depends partly on France for its own credit rating, a French downgrade could undermine the rescue fund just when it is most needed.

If the foundations of the firewall are too shallow, then the bank plan plunges too deep. By the end of June 2012, banks are expected to establish a core-capital ratio of 9%. In principle, that is laudable. But if banks have months to reach their target, they can avoid raising new equity, which would dilute their shareholders' stakes, and instead move to the required ratio by shrinking their balance-sheets. That would be a terrible outcome: by depriving Europe’s economy of credit, it would worsen the downturn.

Then there is Greece. Although the size of the writedown is welcome, euro-zone leaders are desperate for it to be “voluntary”. That is because a default would trigger the bond-insurance contracts called credit-default swaps (CDSs). The fear is that a default could lead to chaos, because the CDS market is untested. That is true, but this implausibly large “voluntary” writedown will lead investors in other European sovereign bonds to doubt whether CDSs offer much protection. So while the EFSF scheme is designed to offer insurance to bondholders, the European leaders’ insistence that the Greek writedown be voluntary will make euro-zone debt harder to insure.

...but trust is nowhere to be found

Europe has got to this point because German politicians are convinced that without market pressure the euro zone's troubled economies will slacken their efforts at reform (see article). Despite a list of promises presented to the summit by Silvio Berlusconi, Italy's prime minister (see article), Germany has good reason to worry. But it needs to concentrate on institutional ways of disciplining profligate governments, rather than starving the rescue package of funds. As it is, this deal at best fails to solve the euro crisis; at worst it may even make it worse. As the shortcomings of each component become clear, investors' fears will surely return, bond yields will rise and banks' funding problems will worsen.

Yet again, disaster will loom. And yet again, the ECB will end up staving it off. Fortunately, Mario Draghi, the ECB's incoming president, made it clear this week that he realises that is his job. But therein lies the tragedy of this summit. An ECB pledge of unlimited backing for solvent governments would have had a far better chance of solving the crisis months ago, and remains the best option today.

At this summit Europe's leaders had hoped to prove that their resolve to back the euro was greater than the markets' capacity to bet against it. For all the backslapping and brave words, they have once again failed. There will be more crises, and further summits. By the time they settle on a solution that works, the costs will have risen still further.

The euro deal

No big bazooka

Europe's leaders have agreed on how to prop up the euro. For now

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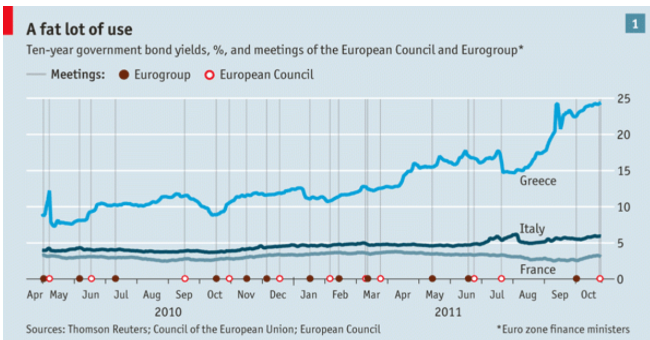
IT WAS four in the morning in the Justus Lipsius building in Brussels when word at last filtered out that, after nearly ten hours of arduous bargaining, the euro zone's leaders had reached the long-promised "comprehensive" deal to save the euro. Diplomats called contacts in the sanctum to find out what, precisely, had been agreed. "We think we have an agreement, but we are not sure what it is," came the reply from one weary negotiator.

By their own admission, the leaders themselves at times struggled to understand the complex financial engineering which they were being asked to approve to turn their inadequate financial slingshot into the "big bazooka" that the world had asked them to assemble. But by dawn on October 27th they could proudly announce a "comprehensive set of additional measures reflecting our strong determination to do whatever is required to overcome the present difficulties".



The result was better than some had dared hope. Just a week earlier the summitry had seemed doomed, with Angela Merkel, the German chancellor (left above), rejecting a push by Nicolas Sarkozy, France's president (right above), to boost the euro zone's bail-out fund by allowing it to borrow money from the European Central Bank (ECB). Unable to cancel a summit planned for October 23rd, the leaders decided instead to call a second one three days later. The ruse worked; the discussions, said one participant, had gone "from worse to bad to better". Markets rejoiced.

But is it a good deal? This was, after all, the third "comprehensive solution" devised by the euro zone so far this year. With each "unprecedented" effort, the problem has only worsened (see chart 1). Sadly, this latest deal promises to be no more enduring. At best, it will buy time before the next round of panic. At worst, it may push the euro zone into catastrophe. "This is certainly no summit to end all summits," said Sony Kapoor, managing director of Re-Define, an economic think-tank in Brussels. "Once again, good economics has fallen victim to bad politics."

The package consists of three connected parts: reducing Greece's debt to a sustainable level by a "voluntary" agreement with private creditors to accept the loss of half the value of the bonds, in exchange for safer debt; recapitalising Europe's banks to the tune of €106 billion ($146 billion) to help them absorb the losses on Greek and other distressed debts; and creating a €1 trillion firewall to prevent the spread of panic to vulnerable, bigger but still-solvent states, above all Italy, the euro-zone country with the second-biggest debt burden. In the word of one well-placed source, "the more zeroes the better". The trouble is, the more zeroes are added, the more holes are likely to be found in the plan.

The good news is that the euro zone has woken up from the lie that Greece could one day repay its debts. A supposedly confidential new assessment of Greece's prospects, drawn up earlier this month by the "troika" of the ECB, the IMF and the European Commission, makes dire reading. Austerity has pushed Greece further into recession than expected; this year output is expected to shrink by 5.5%, and the country will not return to growth until 2013. Moreover, structural reforms to boost growth have been implemented slowly while the forecast for European economies has dimmed, further darkening the outlook for Greece. As a result, the report found that its debt would probably peak at about 186% of GDP in 2013, instead of the 160% predicted three months earlier, even with a 21% haircut on debt held by private creditors that was agreed on in July. If the euro zone and IMF wanted to avoid lending more billions to Greece, private creditors would have to take much bigger losses.

So alongside the bad-tempered bargaining among politicians, there was an equally arduous negotiation with Greece's creditors. At one point on October 26th Mrs Merkel and Mr Sarkozy broke away from the summit to bargain with bankers. The banks would not accept the troika's bleak forecast. A paper produced recently by the Institute of International Finance, a club of big banks that has been negotiating debt forgiveness on their behalf, argued that Greece's public debt would stand at a hefty, though manageable, 122% of GDP by 2015. That always seemed fanciful.

In the end, negotiations settled on a bond exchange that will cut the face value of Greece's debt to private creditors by half. Although the numbers are sketchy, it appears that Greece's partners will have to lend €130 billion, instead of the €109 billion they promised in July. Details of the bond exchange have still to be negotiated with the banks, but it is hoped that it will take place early next year. Taken with the concessionary terms agreed on in July, the package gives Greece its best chance yet of emerging from the crisis. "We finally see hope," said one Greek official.

The bond exchange is billed as "voluntary", but it is not clear that the International Swaps and Derivatives Association, a trade body, will agree. If it judges that a "credit event" has taken place, then payouts will be triggered on credit-default swaps (CDSs), insurance contracts against default on government bonds. This is something that the governments and the ECB had been determined to avoid, fearing it would lead to financial catastrophe, rather as the bankruptcy of Lehman Brothers did in 2008. There is no clarity about who the biggest issuers of default insurance on Greece are. The net exposure on Greek CDSs is thought to be less than €4 billion, though this is likely to be unevenly distributed, with some banks big winners and others big losers. "You don't have to be paranoid to be terrified," says a senior figure involved in the deliberations.

Bankrupting the banks?

Even if the euro zone succeeds in avoiding CDS payouts, this could prove a Pyrrhic victory. If losing half the face value of a bond does not amount to a default, what does? Undermining the value of CDS insurance could deeply distort the market. If banks or other investors lose faith in their ability to hedge risks, they will be tempted to cut back on risk or demand higher yields. So, perversely, sparing a CDS payout on Greece could push up the borrowing costs of other countries.

That said, the danger of contagion is real. If holders of Greek bonds can incur losses on what they once thought were safe investments, what of holders of Italian or Spanish debt? The initial deal on Greek debt in July was followed in August by the dumping of Italian and Spanish government bonds.

One of the obvious channels of contagion is the banking system. So the 27 governments of the EU—both in and out of the euro zone—agreed to force banks to take on more capital to reduce the risk of collapse. The new recapitalisation package will oblige banks to reach a minimum core Tier-1 capital ratio of 9% (somewhat higher than current requirements) by the middle of next year, after recalculating the value of their bond holdings at market prices. That would mean writedowns of Italian and Spanish bonds and gains on German and British ones. This will push much of the burden of raising new capital onto Spanish and Italian banks while leaving British and German ones largely unscathed.

The criteria are suspiciously kind to France. Its banks have been battered in the markets in recent months, and the government is alarmed by the prospect of losing its AAA credit rating. The recapitalisation will be reckoned according to bond prices on September 30th, when French ten-year bonds were still yielding 2.6%. Since then the price has fallen, and the same bonds are now yielding 3.1%. In all, banks will have to come up with €106 billion in extra capital.

That sounds like a lot, yet it is at the lower end of many estimates, largely because it will not include a "stressed" scenario that models the impact of a recession. That may be a mistake, given the slowdown in Europe's economy.

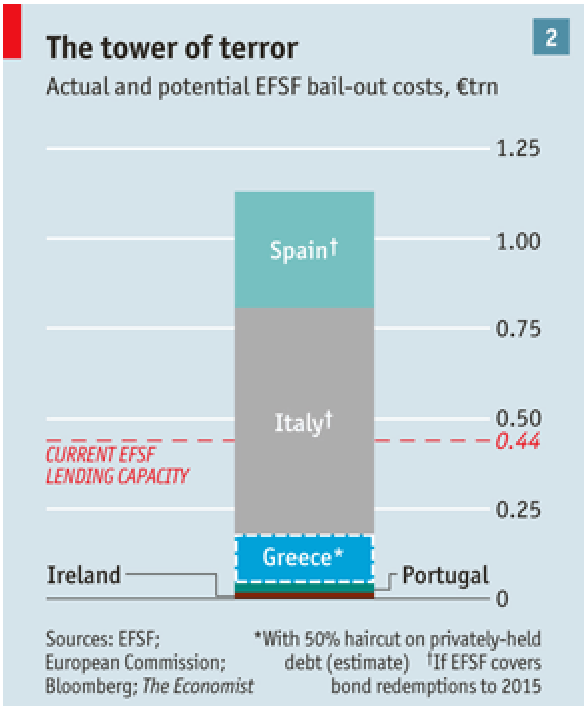
A far bigger mistake is in the plan's timetable. Banks are being given almost nine months to reach the targets, ostensibly to allow them to raise capital themselves through cutting dividends or bonuses and selling shares. Yet few investors are willing to buy bank shares, cheap as they may seem, given the perceived risks of a series of sovereign defaults in Europe. This means that the burden would fall first on national governments and then on the increasingly stretched resources of the European Financial Stability Facility (EFSF), Europe's main bail-out fund.

Given too much time, moreover, there is the risk that banks will, in fact, shrink their balance-sheets to bolster their capital ratios. Their first strategy will be to trim economically essential but capital-intensive businesses such as trade finance or lending to small businesses. Huw van Steenis, an analyst at Morgan Stanley, reckons that European banks may go on a "crash diet" and cut their balance-sheets by as much as €2 trillion by the end of next year. They may also sell government bonds of peripheral countries, worsening the bond-buyers' strike that afflicts Italy and Spain.

Capital is only one issue facing banks. A second is their own ability to borrow. The ECB can step in for short-term funding, but long-term markets are frozen. European banks have, to all intents and purposes, been unable to issue bonds since the start of July. Governments could reopen the market by guaranteeing bonds issued by banks, but they are wary of putting their own public finances at risk; this was the path that led to Ireland's ruin. In any case, few investors would trust guarantees from Italy or Spain.

Debased sovereigns

All this suggests that an essential part of shoring up Europe's banks is to restore faith in government bonds. That means protecting countries, such as Italy and Spain, that are solvent but have lost the confidence of bond investors. Even fundamentally solvent countries can quickly go bust if their borrowing costs rise too fast.



This is where the EFSF comes in. It was designed to protect smaller peripheral states. European policymakers insisted it should have a gold-plated AAA credit rating, lowering its costs but limiting its capacity. It is now too small to shield the bigger economies. The EFSF can lend €440 billion (see chart 2). But given its commitments to Ireland, Portugal, Greece and, perhaps, the recapitalisation of the banks, it may have as little as €200 billion for future contingencies. And yet in the next three years Italy and Spain will have to refinance about €1 trillion-worth of bonds, not counting additional borrowing to finance their deficits.

Countries guaranteeing the EFSF's funds do not want to increase their burden, not least because some cannot afford to do so. France's AAA rating is already at risk. What is more, France and the EFSF are like tottering drunks holding one another up. If France is downgraded, the EFSF will be close behind. How to conjure a bigger EFSF without more taxpayers' money? The answer is "leveraging" through financial engineering of the sort that helped cause the global crisis in the first place. "If you want leverage, you can always find it," says one senior policymaker disdainfully. "Just get two or three investment bankers in a room." Herman Van Rompuy, the president of the European Council, who chaired the summit, sounds even more cavalier. For centuries, he says, banks have taken deposits and used them to multiply money.

The favoured option is to get the EFSF to insure government bonds, acting, in effect, as the issuer of the much-maligned credit-default swap. By guaranteeing to take, say, the first 20% of any loss on government bonds, the EFSF could, in theory, support €1 trillion-worth of Italian and Spanish debt. A second option is to set up SPVs, or Special Purpose Vehicles. These would seek to attract funds from private investors or sovereign-wealth funds in Asia and the Middle East, again by offering to take the first losses in sovereign defaults. In effect they would be creating something that looks a lot like the collateralised-debt obligations (CDOs) that became infamous during the subprime crisis. How much leverage each vehicle would take on, and which countries they might apply to, are questions that still have to be resolved over the next few months.

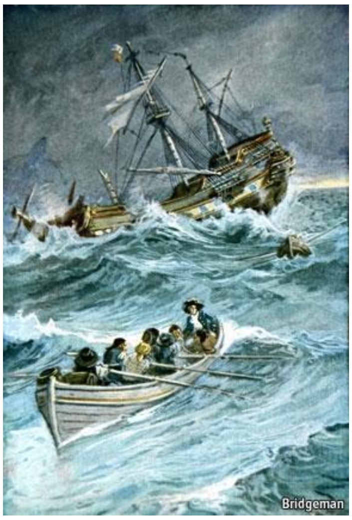
Many wonder why any investor would put money into such vehicles when they can buy bonds directly at a discount or get the insured version. One reason may be that the direct-insurance version may breach "negative pledge clauses" in contracts governing some bonds. These prohibit countries from doing anything that would set holders of new classes of debt above those of the old.

A difficulty with the leverage scheme is that those insuring the debt of euro-zone issuers would themselves be grievously weakened if a neighbour defaulted. How credible can their insurance policy be? "We have really struggled to find investors who want to buy the 'part-insured' government bonds, for fear the insurance is so highly correlated to the risk," says a banker.

An even bigger problem is that levers can work both ways. Leverage may enlarge the size of the fund, but it can also concentrate greater risk onto the sovereigns that guarantee it. If the EFSF were simply to buy the debt of a vulnerable country such as Italy, it would expect to get back more than half of the money even if there were a default with a relatively high haircut of, say, 40%. If, on the other hand, it promised to cover the first 20% of losses on the bonds, then a haircut of just 20% on the value of the insured bonds could wipe out all the money pledged by the EFSF as insurance. So instead of assuaging market fears, leveraging may yet become a mechanism that transmits panic and weakens the sovereigns, above all France. That is why, in practice, the EFSF could probably support Spain or perhaps even Italy, but not both. But it's the only lifeboat on offer.

Debtor, save yourself

The new weapons for the euro zone come with a political price: closer monitoring of national budgets and economic policies, particularly in the case of states that need the greatest help. After a dressing-down from Mrs Merkel and Mr Sarkozy at the first summit, Italy's prime minister, Silvio Berlusconi, came back with a long letter setting out his promises to reform the economy. In December European leaders will consider whether they need to change the EU's treaties to allow more integration. And there is pressure for greater harmonisation of taxes. But even if a re-engineering of the euro zone is possible, such measures are for the longer term, to avoid a repetition of the crisis in the future. The priority must be to deal with the present.



The euro's crisis boils down to this: national treasuries do not have enough spare cash both to guarantee outstanding debt and maintain their own credit ratings. Even mighty Germany cannot stand alone behind the whole euro zone. Some hope that more money can be found from non-European creditor countries, such as China, by convincing them to invest in SPVs. Or perhaps the IMF could do more, particularly if China increases its contribution to the fund. But even if the Chinese were game, this raises a serious political question: does the euro zone want to be so obviously in hock to China just as it is fretting about Chinese firms buying up European ones? "If the Chinese are going to chuck money into an SPV or the IMF there will be a price," says a European diplomat. "The Chinese want two things: one is greater voting rights in the IMF, the other is market-economy status." Such status, which is granted by the EU, would make it harder for the trading block to impose anti-dumping duties on imports from China.

There is a better answer: use the unlimited liquidity that only the ECB can provide by dint of its power to print money. The ECB could credibly stand ready to buy debt of a country like Italy. As such, it would be treating a sovereign almost as it would a bank suffering a run. The danger is that this will stoke inflation. Germany, in particular, has a deep aversion to anything that looks like printing money, an orthodoxy forged in the experience of the Weimar Republic's hyperinflation.

The ECB guards its independence, but has not entirely kept to these rules; it has already gone into the markets to buy distressed bonds, ostensibly to ensure that a country's bond yields do not stray too far from the interest rates the bank sets. Having seen off France's attempt to get the ECB to lend to sovereigns indirectly, through the EFSF, Germany removed even a passing exhortation for the ECB to keep buying bonds from the summit communiqué. "We have no demands and we have nothing to request," said Mr Van Rompuy.

In private, though, most hope the ECB will not withdraw from bond-buying. Its incoming president, Mario Draghi, who takes over from Jean-Claude Trichet on November 1st, has signalled his willingness to buy bonds to ensure the transmission of monetary policy. "The blanket prohibition against directly lending to governments is a complete idiocy," says Willem Buiter, chief economist at Citigroup, and a former member of the Bank of England's monetary-policy committee. "That is what central banks do. Just because it can be mismanaged does not mean you have to throw the tool away. You can drown in water, but it does not mean you cannot have a glass when you are thirsty."