Observation

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EUROPEAN RESPONSE TO FISCAL CRISIS REMAINS INADEQUATE

Only two weeks ago, European leaders had agreed to a second bail-out program for Greece and a number of other measures intended to stave off contagion risks into Spanish and Italian sovereign debt markets. The announcements helped to bring down interest rates on Greek, Irish, and Portuguese debt, but they did little to assuage bondholders' concerns regarding Italian and Spanish fiscal sustainability. Last Thursday Italy's 10-year bonds traded at 6.20%, a whopping 3.90 percentage points over equivalent German bunds – a record high since the inception of the euro. The same story with slightly different figures played out that day for 10-year Spanish bonds.

On Friday, after European markets closed, Italian Prime Minister Berlusconi announced plans to accelerate fiscal consolidation in order to close Italy's fiscal deficit by 2013, a year ahead of what had been announced just two weeks ago. He also announced a plan to amend the constitution to make a balanced budget a mandatory criteria, to speed up of welfare reforms, and to improve economic growth through other structural reforms.

Later that day, news broke that the Standard &Poor's rating agency had downgraded the U.S. long-term credit rating one notch to AA+. This triggered emergency meetings among G7 finance ministers and central bank governors. The European central bank (ECB) signaled it was prepared to purchase Italian and Spanish bonds, something it had resisted last Thursday amidst market turmoil. Although four of its 23-member strong governing council opposed such intervention, the ECB made good on yesterday's promise. Significant interventions in the secondary market have lowered Italian and Spanish yields by roughly 1 percentage point.

To understand why this is happening, we need to recap the policy measures adopted during the July 21st emergency summit. However, to provide context, we will first revisit some of the main characteristics of the European Financial Stability Facility (EFSF).

The EFSF structure

The EFSF is a corporation the euro zone member states established in June 2010 after the first Greek bail out, in order to assist countries under financial stress. To do so, the EFSF can issue debt guaranteed by its founding members for up to € 440 billion. The guiding principle was that those guarantees, combined with an additional 20% guarantee buffer, would allow the EFSF to obtain the strongest credit rating possible, thereby reducing its funding costs. Indeed, the three leading credit rating agencies assigned the EFSF their highest rating.

In order to secure a loan from the EFSF, a country has to sign an agreement, which stipulates the criteria for budgetary discipline and economic policy guidelines similar to those traditionally requested by the IMF.

Before each disbursement, the European Commission will, in liaison with the ECB, present a report analyzing compliance by the relevant borrower with the terms and conditions of the agreement. The guarantors will evaluate such compliance and will unanimously decide on whether to permit disbursement of the loan.

In the event that a guarantor requests a stability support loan to the EFSF, it becomes a "stepping-out guarantor", withdrawing its commitment to provide further guarantees. Therefore, any future guarantees would be issued by the remaining guarantors. To that effect, their contribution shares should be proportionally adjusted.

The latter constitutes the main weakness of the EFSF, which is that as the demand for financial aid increases, the pool of countries providing the guarantees behind EFSF debt declines. Correspondingly, the financial liabilities of the EFSF could call into question the credit ratings of the guarantee nations.

Delay on implementation is becoming critical to markets

On July 21st, European leaders decided to enhance the EFSF by allowing it to:

1. Act on the basis of a precautionary program;
2. Finance recapitalization of financial institutions through loans to governments including in non-program countries;
3. Intervene in the secondary markets on the basis of an ECB analysis, and on the basis of a decision by mutual agreement of the EFSF member States.

Although positive, the lack of critical details on how these measures will be implemented has undermined the effort. Moreover, these modifications still have to be ratified by the Parliaments of each member state, which constitutes a critical step. Yesterday, German Chancellor Angela Merkel and French President Sarkozy issued a joint statement in which "they stress the importance that parliamentary approval will be obtained swiftly by the end of September in their two countries". The issue here is that from a political perspective, "end of September" may seem swift, but from the markets perspective, it may seem like an eternity. Hence the arm twisting within the ECB governing council to get the central bank to buy sovereign bonds forcefully enough to calm the markets in the interim.

EFSF not a silver-bullet solution

Italy faces principal and interest payments of roughly €173 billion throughout the end of 2011, and €174 billion during the first half of 2012. The Spanish equivalent figures are €81 billion and €71 billion, respectively. If confidence in these countries is not restored quickly, the ECB will have to buy bonds by an amount that would certainly exacerbate the divisions within its governing council. The ECB secondary market interventions have so far been justified under the premise they would be sterilized via open market operations to avoid an increase in money supply. The size of the secondary market interventions required to stabilize Italian and Spanish yields would make full sterilization impossible. Therefore, in the eyes of the most orthodox ECB council members, that would look a lot like monetization of fiscal deficits; something that is unacceptable for Germany.

Furthermore, there are significant risks that approval of these EFSF modifications will not go smoothly in a few countries. Political resistance will be high in Germany, Finland, the Netherlands, and Luxemburg. Together with France, they are the ones with triple-A credit ratings that provide the bulk of credit quality backing for the EFSF. They would also be the ones providing the bulk of guarantees if Spain and Italy were to request assistance from the EFSF. In Germany, opposition parties have threatened to challenge the latest EFSF amendments in the Constitutional Court. We have long warned that political risks could undermine the smooth functioning of the EFSF. Given that each disbursement needs to be approved unanimously by participating guarantors, domestic social pressure might become a strong conditioning factor for approving a disbursement, especially in the event that a borrower misses some of the fiscal performance targets of its agreement.

Another risk stems from the impact that the U.S. sovereign credit downgrade could have for the euro zone. Despite reassurances from credit rating agencies, a downgrade of France's triple-A credit rating could occur. This would imply that four countries – France, Italy, Spain, and Belgium – providing roughly 57% of total guarantees for the EFSF have lower than triple-A ratings, which would call into question the triple-A credit rating of the EFSF itself. This raises doubts about the capability of the fund to perform the critical tasks it needs to carry out. For instance, under these circumstances, it is unlikely the EFSF will be able to issue debt at a 3.5% interest rate, which is what European leaders vowed they will charge Greece, Ireland, and Portugal going forward. Even if France is not downgraded as a fallout of the U.S. downgrade, it is still questionable whether the good credit of Germany and France would be unaffected when they absorb their shares of the potential EFSF liabilities.

Concluding thoughts

As we noted in our July 22nd Observation, the initial progress made in restructuring the EFSF was positive, but was not the game changer that markets were demanding. The delay in implementing the expanded role of the EFSF and the necessity of expanding the size of the EFSF has perpetuated market jitters. And, uncertainty continues to swirl regarding the impact potential EFSF liabilities will have on the main guarantors. While EU members continue to take steps to ward off market angst over sovereign debt levels, this is not an issue that will be easily or quickly resolved, and we can expect to see ongoing bouts of market volatility.

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