OBSERVATION

TD Economics

October 27, 2011

EUROPEAN SOVEREIGN DEBT PLAN: NAVIGATING A SEA OF MISSING DETAILS

The euro zone leaders have outlined a substantive new plan to address their fiscal crisis. This was absolutely critical. Had they been unable to reach an agreement, a deeper financial crisis would likely be unfolding. However, the plan lacks details. Our assumptions about how the plan might be implemented raise the possibility that the new proposals may not be adequate to fully address the fiscal and financial challenges facing Europe. In this note, we outline the key measures of the new plan, highlighting some critical aspects that would ultimately condition the success of this latest attempt to put the European fiscal crisis on a path to resolution.

A new Greek debt swap with a nominal discount of 50% on private sovereign debt holdings. The objective is to bring Greek debt down from a projected peak of 186% of GDP in 2012 to 120% of GDP by 2020. This debt swap has been negotiated with the Institute of International Finance, a lobby group representing banks. Euro zone countries will contribute €30 billion to ease the terms of the exchange. Details on the implementation have yet to be worked out among interested parties to ensure "voluntary" participation. This is critical to avoid a credit event that would trigger credit default swaps. The debt swap should be completed early next year.

A new EU-IMF multi-annual program financing up to €100 billion will be put in place by the end of this year. This amount includes €30 billion to recapitalize Greek banks. It will be accompanied by a strengthening of the mechanisms for the monitoring of implementation of the reforms.

Our view: The first debt swap proposal of July 21st sought a reduction in net present value of 21% and a voluntary participation rate of 90%. The latter was not achieved. Therefore, the stakes are very high to reach a larger participation in this second attempt on a strictly voluntary basis. Moreover, if investors are wary about Italian debt at 121% of GDP today, what would convince them that Greek debt will be sustainable at 120% of GDP in 2020? Furthermore, even if there is complete participation, a 50% haircut on privately held Greek debt may not be enough to create fiscal sustainability for Greece. For for it to be adequate, the country would have to return to positive economic growth in the short term, stick to its privatization program, achieve its fiscal consolidation targets, regain and maintain access to private funding. If any of these prerequisites does not hold, then there will be either a need for further write-downs or more financial assistance from euro zone neighbors.

Ultimately, orderly or disorderly, voluntary or coercive, a deeper Greek debt restructuring will likely have to happen. How and when it happens will determine the fallout across the European banking system and the degree of contagion into other sovereigns' debt. Having said that, the 50% haircut on Greece bonds would be a step down the path of resolution.

Optimization of the resources of the European Financial Stability Facility (EFSF). This will be achieved in two ways: 1) the EFSF will offer guarantees to private investors buying bonds in the primary market; 2) EFSF funds will be used to set up special purpose vehicles to attract private and public investors into buying sovereign debt in primary and secondary market. Implementation of these

Craig Alexander, Chief Economist and SVP, 416-982-8064
Martin Schwerdtfeger, Senior Economist, 416-982-2559

schemes has a potential market impact of around €1 trillion. The Eurogroup will finalize the terms and conditions for the implementation of these modalities in November.

Our view: It is premature to make an assessment on the new EFSF capabilities without any of the critical details governing its functioning; especially when there is still lack of clarity on the implementation of many of the EFSF modifications agreed upon on July 21st. How much demand there will be for sovereign debt and how much lower the interest rates paid will be due to EFSF guarantees would depend on how things are implemented. Thus, markets will be hanging in the dark until those details are hashed out.

Measures to strengthen banks' capital positions. Banks are required to build up a temporary capital buffer against sovereign debt exposures to reflect current market prices. In addition, banks are required to reach a Core Tier 1 capital ratio of 9% of risk weighted assets. Banks will be expected to build these buffers by the end of June 2012. Based on market valuations as at September 2011 and reported bank exposures as at June 2011, the European Banking Authority (EBA) has estimated the sovereign debt buffer would amount to €40.6 billion, and capital needs would rise to €106.5 billion. Final estimates will be produced once data on bank exposures as of September 2011 become available. To finance this capital increase, banks should first use private sources of capital, including through restructuring and conversion of debt to equity instruments. The targets will have to be achieved avoiding excessive deleveraging, so as to contain the potential impact on the real economy. Banks would be subject to constraints regarding the distribution of dividends and bonus payments until the target has been attained. If necessary, national governments should provide support, and if this support is not available, recapitalization should be funded via a loan from the EFSF in the case of euro zone countries.

Our view: The EBA did not conduct a fresh round of stress tests. Therefore, the capital needs it has estimated only reflect the impact of current market valuations of sovereign bonds. It leaves out of the equation what would be the impact on banks' balance sheets of other shocks such as a deterioration in economic growth across the euro zone. With the latest economic indicators pointing to a significant deceleration in economic activity in the common currency area, it is very likely that a few months from now the current capital needs will be deemed inappropriate. This is particularly relevant for both Irish and Spanish banks, which have large exposures to real estate loans. Against a backdrop of persistent market volatility and weaker economic activity, it is somewhat unrealistic to expect banks would be able to avoid "significant deleveraging". In the aggregate, until confidence in the banking system is fully restored, deleveraging will have to occur, either via mergers and consolidations or through balance sheet reductions. This will inexorably further undermine economic growth, especially given the fact that European banks constitute a much larger conduit for financing economic activities relative to their U.S. counterparts.

Restoring banks' access to term funding. The EBA has been asked to work with the EU Commission, the European Central Bank (ECB) and European Investment Bank (EIB) to design public guarantee schemes to support banks' access to term funding at reasonable conditions. This initiative aims to forestall a dramatic deleveraging process, which could ensue from the combination of banks efforts to raise their capital levels and their inability or unwillingness to do so by raising fresh capital in the markets.

Our view: This is a positive effort given that a coordinated approach among member states will certainly have a more effective impact on overall funding conditions across Europe than individual initiatives. Nevertheless, the details will decide how attractive this will be for banks in terms of pricing. Moreover, there will be varying degrees of credit risk mitigation depending on which European sovereign is providing the guarantees. The latter will prove particularly relevant for cross-border transactions.

Italy commits to further structural reforms. Italy had already committed to achieve a balanced budget by 2013 and a structural budget surplus in 2014, bringing about a reduction in gross government debt to 113% of GDP in 2014. Italy will now implement the proposed structural reforms to increase competitiveness by cutting red tape, abolishing minimum tariffs in professional services and further liberalizing local public services and utilities. The country also plans to increase the retirement age to 67 years by 2026.

Our view: There is a long walk from announcement to implementation. Unfortunately, many European countries have shown a persistent tendency to crawl instead of running towards reform. Therefore, implementation risks will remain at the root of the matter.

Strengthening the Economic Union. An interim report elaborated by the President of the European Council, the President of the Commission, and the President of the Euro-

group will be presented in December 2011. It will identify possible steps to strengthen the economic union, including exploring the possibility of limited Treaty changes. A report on how to implement the agreed measures will be finalized by March 2012.

Our view: This type of endeavor will yield results many years down the road. Unfortunately, this crisis has to be tackled today. Nevertheless, progress on this front would bring the euro zone gradually closer to a fiscal union. This has been a key vulnerability of the common currency area. The recent fiscal crisis is to a large extent the product of the absence of a common Treasury. If the euro is to survive, a new fiscal framework must be introduced.

Final remarks

Once again, as it had been the case on July 21st, European leaders have delivered a skeleton of policy measures very thin on critical details. Forget the rally in equity shares of today, focus on the sovereign bonds' market reaction: Italian, Spanish, and Irish yields have been trading only a few basis points below the levels observed yesterday. Even in the very short term yesterday's announcements leave open some important logistical questions. For instance, assuming everything runs smoothly, the new Greek debt swap is scheduled to be completed by early next year. On the other hand, the new EU-IMF program for Greece should be completed by the end of this year. What will happen if come December, Greece misses a few of its original program targets – which in turn would compromise its debt sustainability analysis – and the private sector involvement is not finalized yet? We will be having exactly the same discussion we have been having over the last three months and Greece will once again be facing the risk of a technical default.

Nevertheless, we ought to give credit to European leaders for actually agreeing on these measures. Had they failed to wrap up the summit with a set of announcements of this nature, today we would be discussing the imminent prospects of a systemic banking crisis. While we feel the new plan is likely inadequate, there is no question that in many aspects it represents a step in the right direction.

Craig Alexander
Chief Economist and SVP
416-982-8064

Martin Schwerdtfeger
Senior Economist,
416-982-2559

This report is provided by TD Economics for customers of TD Bank Group. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Group and the members of TD Economics are not spokespersons for TD Bank Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.