OBSERVATION

TD Economics

December 9, 2011

EUROPEAN SOVEREIGN DEBT CRISIS: BUILDING A FISCAL COMPACT

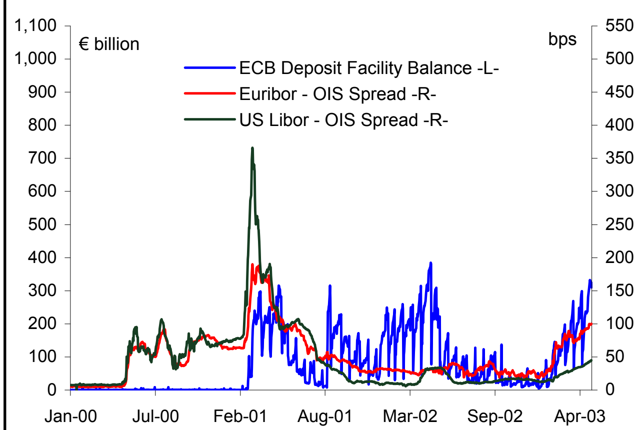
Highlights

- European leaders held a two-day summit in Brussels to discuss changes to the European treaties that could bring the euro zone closer to a fiscal union and put the sovereign debt crisis on a path to resolution
- However, significant risks loom over the implementation of these measures
- Therefore, European sovereign bond yields will test new highs before these measures come to fruition
- On the positive side, the European Central Bank has delivered a few policy actions that will help to thaw a growing banking funding freeze

European leaders held a two-day summit in Brussels to discuss changes to the European treaties that could bring the euro zone closer to a fiscal union. They did this not on their own volition, but because the sovereign debt crisis has cornered them, and failure to move forward would risk a break up of the common currency area. Thus, this summit could not only shape the European economic and political landscape for decades to come, but could also dictate whether the global financial system is thrown into the eye of a hurricane in a matter of weeks.

Setting the stage for the already high-stake summit, the European Central Bank yesterday made very clear that its governing council does not intend to paper over with cash the cracks on the European institutional foundation. However, the fiduciary authority delivered a few policy measures that would defuse – to some extent – the funding pressures that have been affecting the European banking system and threatening to become a fully fledged credit crunch.

INTERBANK FUNDING STRESS



Source: Bloomberg

No White Knight is riding to the rescue

Yesterday the European Central Bank (ECB) decided to lower its policy interest rate by 25 basis points to 1.0%. It also expanded its non-standard measures to address the tightening of credit conditions that has been taking place across the euro zone in recent weeks.

Martin Schwerdtfeger, Senior Economist, 416-982-2559

The main measures delivered by the ECB were:

- The introduction of two longer-term refinancing operations (LTROs) with a maturity of 36 months to be conducted this month and in February 2012. The operations will be conducted as fixed rate tender procedures with full allotment and will have the option of early repayment after one year.
- The expansion of collateral availability by (i) reducing the rating threshold for certain asset-backed securities and (ii) allowing national central banks, as a temporary solution, to accept as collateral additional performing credit claims (i.e. bank loans) that satisfy specific eligibility criteria.

These two measures should have a positive impact on European banking funding conditions. However, an estimated banking debt roll-over of at least €200 billion in the first quarter of 2012 will still pose a significant hurdle for some European banks. More so because it will coincide with the end of the government guarantees on bank debt established in the aftermath of Lehman's fall in 2008. Indeed, in recent weeks, European banks have been increasingly reluctant to lend to each other, even as they continue to build cash balances at the ECB. At the same time, the deterioration in sovereign bond valuations has further exacerbated the lack of good quality collateral to access the emergency liquidity lines of the ECB. This situation could get worse if rating agencies downgrade some of the European sovereigns they have recently placed on negative credit watch.

However, the most important aspect of yesterday's ECB meeting was what Mr. Draghi delivered during the press conference, as he addressed questions on some of the potential actions the ECB could adopt to further stem the escalation of the crisis.

For instance, Mr. Draghi reiterated that ECB actions are governed by the provisions in the European treaties, which forbid the central bank to finance fiscal deficits through money creation. In line with this, he stated that the Securities Market Program (SMP), through which the ECB has been buying sovereign bonds, is neither eternal not infinite.

Mr. Draghi noted that the same guiding principle would prevent ECB from providing funds to the IMF, if the latter were to use them to grant loans to embattled euro zone countries. Furthermore, Mr. Draghi also highlighted the very complex legal nature of this action, stressing that the ECB is not a member of the IMF. Moreover, when asked how would the governing council react if a national central bank were to engage in such activity, he once again stressed that any action that could be considered monetization of fiscal imbalances of a member state would breach the spirit of the treaties. However, he also stated that it would be a different situation if a national central bank would lend money to the IMF to assist a country outside the euro zone.

The president of the ECB dispelled another idea that had gained some traction among market analysts; namely, the possibility that the ECB might engage in large scale buying of securities, akin to the quantitative easing (QE) programs of the U.S. Federal Reserve. Mr. Draghi noted that the governing council had not even discussed that option, and mentioned that the institutional frameworks in which both central banks operate are very different. He stressed that the Fed has a dual mandate for maximum employment under price stability, whereas the ECB as only a mandate to maintain price stability. Mr. Draghi further added that the governing council sees no material risk of deflation in the euro zone at this stage, which suggests economic conditions would have to deteriorate dramatically before the ECB launches QE.

Draghi's Fiscal Compact

Financial markets reacted negatively to those remarks because in a speech to the European Parliament last week, Mr. Draghi had mentioned that if European leaders could secure a new "fiscal compact" then "other elements would follow". Market commentators saw this as an indication

SOVEREIGN DEBT REDEMPTIONS (principal | interest; € billion)

	Belgium		France		Germany		Greece		Ireland		Italy		Portugal		Spain	
Dec-11	6.84	0.62	29.98	0.47	35.50	0.59	6.87	0.12	0.00	0.04	22.46	1.70	2.28	0.09	12.08	0.15
Jan-12	7.37	2.04	49.52	2.72	51.25	12.76	4.02	0.35	0.00	0.47	15.60	1.27	3.96	0.01	9.18	6.16
Feb-12	7.16	0.04	36.16	0.46	13.00	0.92	2.30	0.21	0.00	0.00	53.14	9.91	4.00	0.26	14.66	0.37
Mar-12	9.62	6.48	25.93	0.00	31.25	0.59	15.89	1.56	5.55	0.66	44.20	7.42	2.78	0.05	8.82	0.64
Apr-12	3.45	0.02	34.39	15.90	30.64	3.53	1.60	0.47	0.00	1.30	44.09	2.30	0.43	0.58	22.72	4.01
May-12	2.46	0.03	19.00	0.00	17.09	0.16	10.05	1.50	0.00	0.00	15.17	4.28	0.35	0.02	8.51	0.40
Jun-12	1.84	0.26	7.81	0.00	30.11	0.86	0.55	0.44	0.00	0.34	8.36	2.84	10.16	1.88	6.51	0.23

Source: Bloomberg, TD Economics

that the ECB was reading itself to intervene more forcefully in the sovereign bond markets. Thus, financial markets reacted negatively when Mr. Draghi turned down those expectations. Furthermore, to dispel any element of confusion, the president of the ECB specified what he meant by a fiscal compact: a new fiscal pact among European Union countries grounded on three pillars:

1) national economic policies geared towards fiscal stability, economic growth and competitiveness;
2) fiscal rules enshrined in primary European legislation (i.e., the treaty) establishing limits to structural deficits and debt levels with automatic sanctions. These fiscal rules would condition ex-ante the budgets of each member state; and,
3) an stabilization mechanism, which Mr. Draghi would prefer to be embodied by a fully functioning EFSF/ESM – rather than the ECB itself.

Finally, Mr. Draghi closed his remarks on the fiscal compact by stressing that "it is very important to have a credible legal process, but it is equally important to have something that would be in place soon".

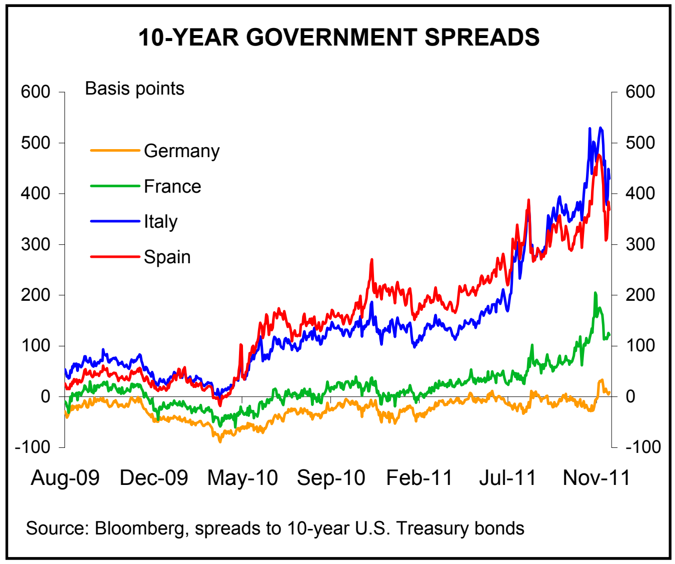
Has the European Summit delivered the "fiscal compact"?

After the first session of deliberations carried out yesterday, the answer appears to be yes, but not fully. European leaders did not reach agreement at the European Union level on the introduction of a new fiscal rule to the European treaties. The United Kingdom rejected a treaty change to introduce such rule.

As a result, the 17-member euro zone has moved forward to introduce an intergovernmental treaty, to be finalized at the latest by March 2012, binding them to achieve a structural fiscal deficit that does not exceed 0.5% each year. This rule should be enshrined in each country's constitution. Bulgaria, the Czech Republic, Denmark, Hungary, Latvia, Lithuania, Poland, Romania and Sweden indicated the possibility to take part in this process after consulting their Parliaments where appropriate.

The fiscal rule will also contain an automatic correction mechanism, to be defined by each member state based on principles proposed by the European Commission. Note that this is not the same as "an automatic sanction", as called for by Mr. Draghi.

Regarding the stabilization mechanisms, the European Financial Stability Facility (EFSF) leveraging will be rapidly deployed, having the ECB acting as an agent for the EFSF market operations. Leaders also agreed on an acceleration of the entry into force of the European Stability Mechanism (ESM) treaty. The treaty will enter into force as soon as member states representing 90 % of the capital commitments have ratified it, ideally by July 2012. The adequacy of the overall ceiling of the EFSF/ESM of €500 billion will be reassessed in March 2012.



In addition, the new ESM treaty will remove the mandatory private sector participation in future ESM financial assistance programs, although debt renegotiations could still take place under the "well established IMF principles and practices". However, standardized and identical Collective Action Clauses will still be included in all new euro government bonds.

Voting rules in the ESM will be changed to include an emergency procedure. The mutual agreement rule will be replaced by a qualified majority of 85% in case the Commission and the ECB conclude that an urgent decision related to financial assistance is needed when the financial and economic sustainability of the euro area is threatened.

Euro area and other member states will consider, and confirm within 10 days, the provision of additional resources for the IMF of up to €200 billion, in the form of bilateral loans. European leaders signal they are looking forward to parallel contributions from the international community. Some countries have signaled their intention to participate, but we should watch how the U.S. measures up against the European expectations in the midst of its presidential campaign.

In all, these elements laid out in the summit do represent some progress; but with the usual caveats of implementation risks. For instance, Ms. Merkel will very likely have to seek approval from the German parliament to provide the IMF with additional funds. The Irish government, in turn, depending on the final form the fiscal rule adopts, might have to hold a referendum to decide whether it can introduce it. Besides the numerous other obstacles that will likely appear once the summit's policy initiatives hit domestic ground on each member state, there is still the issue of not enough money being available to fund hypothetical Italian and Spanish bail-outs. Even if emerging markets were to match-up the still-to-be-ratified €200 billion European contribution to the IMF, the multinational institution would still struggle to offer its customary 3-year programs to those two countries, let alone anybody else.

Final Remarks

In all, has the European Union summit delivered enough of the elements of the "fiscal compact" as to kick start the process of rebuilding confidence in the euro zone and set the ground for an expanded ECB role? "It is still too early to tell" has become the standard answer to this question after each summit. A lot will depend on the implementation of these measures, and both timing and avoiding implementation risks remain of the essence. Moreover, there will be several instances to test market confidence before we get to the March 2012 summit. For instance, Greece is about to undergo the first review of its second bail-out program. In addition, European banks will have to lay out plans by January 20th to fill in the €115-billion capital shortfall just published by the European Banking Authority. Moreover, in February, Italy alone has to redeem €53.1 billion in maturing debt. Against this backdrop, European sovereign bond yields will test new highs before the measures announced at the summit come to fruition.

Beyond these concerns, there is the erosion of economic growth that harsh, across-the-board fiscal tightening will impose on the euro zone next year. With the European banking system engaged in a deleveraging process, there is every reason to doubt how much of an offset laxer monetary policy could offer.

No matter how hard one tries, it is very difficult to find a positive angle from where to look at this crisis. But we should keep trying, because at the end of the day the world will still be standing. We just have to make it through to the other side.

Martin Schwerdtfeger
Senior Economist
416-982-2559