

Schroders QuickView



Eurozone crisis update: Done deal

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27 October 2011



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- **Overall, there are a lot of details still missing from the plan, though we are encouraged that European politicians are moving in the right direction. The deal should help reduce the volatility in financial markets, though the damage may have already been done to the real economy**
- **We expect the eurozone economy to slow significantly by the end of the year, though the deal done may have helped avoid a second global credit crunch and a very deep recession.**

Leaders from the eurozone and the wider EU met yesterday to thrash out a solution that they hope can finally stem the contagion spreading from the European sovereign debt crisis. Late into the night, an announcement was finally made that followed the three pillars we set out in the September Economic and Strategy viewpoint. The agreement includes:

- Private investors will be asked to voluntarily partake in the restructuring of Greek debt, which will be the equivalent of taking a 50% nominal haircut.
- The European Financial Stability Facility (EFSF) will be made more effective by 1) offering insurance on new government debt to be issued and 2) being increased in size using a Special Purpose Vehicle, which both public and private money will fund.
- European banks will be forced to meet a new higher Tier 1 capital ratio of 9% but with regulators ensuring that the deleveraging process does not involve a reduction in credit to the real economy. Banks are asked to raise capital from private investors first, and failing that, receive help from national governments. €100billion of loans will be made available from the EFSF.

In addition to the above, the changes to the EFSF's powers agreed on the 21st of July are now in force. This means that the EFSF can buy bonds in secondary markets either in conjunction with, or taking over from, the European Central Bank.

Finally, plans were announced to increase political and fiscal integration, mainly through more scrutiny of fiscal plans through the existing peer review process. We believe that these are the first steps towards a fiscal union, though we may be many years away from the model being completed.

In our view, these are very positive steps in the right direction which reinforces our view that European politicians are willing to take unprecedented action to keep the European Monetary Union together. However, the deal is not totally finalised, and we must wait for more details on each of the three pillars of the solution.

For example, the eventual lending capacity of the EFSF has yet to be agreed. Hints of increasing its current lending capacity of between €200billion and €250billion by three or four fold has prompted headlines of €1trillion being made available. Certainly if the insurance strategy only covers the first 20-25% of losses on peripheral sovereign debt, then this would be the case. €1trillion would be enough to support Italian and Spanish funding until around 2014. The problem with this assumption is that it relies on the market being willing to buy the bonds with the insurance - which is not guaranteed.



In addition, the full details of the Greek restructuring are unlikely to be available until the end of the year, with the EU targeting implementation at the start of 2012. It appears that the announced measures have the support of the vast majority of creditors. However, we still have no confirmation of the extent of the voluntary take up. The hope is that taking the haircut together with Greece's austerity programme and the support provided by the EU and IMF that its debt level can fall to 120% of GDP by 2020. We would argue that this level is still too high and that haircuts on publicly owned Greek debt will be required. Why target 120%? Probably as it makes Italy appear more sustainable than it actually is.

The deal announced also provides a green light now for Greece to receive its September tranche of loans, which the IMF has already agreed to disburse. Interestingly, we may now see a permanent presence of the Troika (ECB, European Commission, IMF) in Athens to help with the implementation of fiscal and structural reforms.

Other details that are missing include:

- How will the IMF respond to the deal? Will it also provide additional funding?
- What happens if the funding cost of the EFSF rises? Will the EU pass on the increased cost to the bailed out governments?
- What role will the ECB play going forward? Is it still expected to purchase government bonds even though the EFSF now has the power to do so?

Overall, there are a lot of details still missing from the plan, though we are encouraged that European politicians are moving in the right direction. The deal should help reduce the volatility in financial markets, though the damage may have already been done to the real economy. We expect the eurozone economy to slow significantly by the end of the year, though the deal done may have helped avoid a second global credit crunch and a very deep recession.

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