

14 December 2010

EUROPEAN COUNCIL, DECEMBER 2010 - THE QUESTIONS THAT NEED ANSWERS

Summary:

Will EU leaders have to increase the size of the existing bail-out package?

- It is far from clear that the current bail-out package is big enough to ensure market stability should Portugal and Spain – and even Italy – come under increased pressure. While they will dodge the question this time around, eurozone leaders may well have to increase the size of the bail-out fund before it expires in 2013. The total amount of the aid scheme on paper is €750 billion. However, the real amount available could actually be closer to €410 billion because not all of the countries signed up to the fund will be able to contribute due to the poor health of their own public finances.
- According to a conservative Goldman Sachs estimate, taking Ireland, Portugal and Spain out of the bond markets for two years will cost €450 billion.

How will the permanent eurozone crisis fund work?

- EU leaders are likely to agree to a limited Treaty change to allow for the establishment of a permanent eurozone bail-out fund, known as the European Stabilisation Mechanism. This new mechanism will move some of the risk away from taxpayers to banks and investors, where the risks belong, by allowing euro countries to restructure their debts and investors to face haircuts.
- However, the crisis mechanism is still surrounded by huge uncertainties, including the problems involved in giving the European Commission, the IMF and the ECB – three undemocratic institutions – new powers over a country's economic future. Germany is likely to push for the strongest possible Treaty clause, which would make a strict link between aid and budgetary consolidation.

Is there a future for eurozone bonds?

- German Chancellor Angela Merkel has made it clear that E-bonds are not on the agenda. However, should the eurozone crisis worsen, more EU leaders could come to see E-bonds as one of few available options to save the eurozone from imploding.

- But while a common bond would knit eurozone economies closer together, it is not clear whether E-bonds would actually lower overall borrowing costs for eurozone economies. E-bonds would also reduce the incentive for weaker eurozone economies to be fiscally responsible.

Should the ECB continue to finance governments and bail out banks?

- Although it is meant to be politically independent, the future role of the ECB is likely to be discussed at the summit in some way. The ECB is likely to come under pressure from countries such as Spain and Italy to expand its purchase of bonds in order to stifle the risk of contagion from Ireland and Portugal. This is something which will be resisted by Germany. But in the absence of other credible solutions, the ECB is likely to continue its interventionist programme, akin to 'quantitative easing'.

How big will the 2011 EU budget be?

- Ahead of the meeting of EU leaders, the European Parliament is likely to approve a deal similar to that offered by national governments at the last Council meeting, which will see the 2011 EU budget increase by 2.9% to €126.5 billion¹.

¹ *European Parliament press release*, 'Parliament to vote on EU budget for 2011', 10 December 2010; <http://www.europarl.europa.eu/en/pressroom/content/20101210IPR08950/html/Parliament-to-vote-on-EU-budget-for-2011>

1. Will EU leaders have to increase the size of the existing bail-out package?

The draft Council conclusions² do not mention anything about increasing the size of the current bail-out package available to eurozone countries in financial difficulties, in total worth €750 billion (with €250 billion coming from the IMF). However, it is clear that this is one of the key questions EU leaders are facing and it is likely to be discussed in the corridors of the meeting on Thursday and Friday.

The IMF has argued that,

“There is also a strong case for increasing the resources available for this safety net and making their use more flexible, including for the purpose of providing more effective support to banking systems.”³

According to some reports, the European Commission floated a proposal to double the EU's €440 billion European Financial Stability Facility (EFSF) earlier in the year.⁴ Belgian Finance Minister Didier Reynders has also said that that the fund should be endowed with “a huge amount of money, because if we don't do that you always have speculation.”⁵

Germany, backed by France, has flatly rejected calls to increase the EFSF, with the German Finance Ministry saying that the question “does not arise at present”, claiming that the guarantees already available “are entirely sufficient.”

Another suggestion has been for the EFSF to purchase eurozone government bonds in an effort to narrow bond yields and reduce borrowing costs for struggling economies. However, Germany has also voiced opposition to this move, pointing out that the current EFSF agreement prohibits such a strategy⁶.

Is the current bail-out package really big enough?

The draft conclusions state that a new European Stability Mechanism, which would constitute a permanent bailout fund, should be up and running as of 1 January 2013, six months ahead of schedule. The shortened timescale is perhaps an indication of fears in Germany and elsewhere that the current bail-out package may not be big enough to calm markets if more eurozone countries – Spain in particular – would find it difficult or prohibitively expensive to finance themselves.⁷

The total amount of the current aid scheme on paper is €750 billion.⁸ However, the real amount available is something closer to €409 billion.

² See the draft conclusions here: <http://www.eu-oplysningen.dk/upload/application/pdf/5a463a92/2010Raad1617dceBilag2.pdf>
³ <http://www.telegraph.co.uk/finance/financetopics/financialcrisis/8182765/IMF-urges-EU-to-boost-500bn-bail-out-fund-to-stem-crisis.html>

⁴ <http://www.openeurope.org.uk/media-centre/summary.aspx?id=1245>

⁵ <http://www.google.com/hostednews/afp/article/ALeqM5gldg-D8k4PWKG0g69-Csve6j8P4g?docId=CNG.eb6f793d7e091dc5315bb6b6cbcea713.c81>

⁶ *iMarketNews*, ‘Germany's Govt: Oppose Idea Of EFSF Buying Up EMU Govt Bonds’, 13 December 2010; <http://imarketnews.com/node/23845>

⁷ The draft conclusions also state that “any private sector involvement based on these terms and conditions would not be effective before mid-2013”. This means that the new mechanism will start, in January 2013, before private bondholders are being involved, mid-2013.

⁸ Composed of €440 bn provided by Eurozone countries (EFSF); €60 bn provided by EU countries (EFSM); €250 bn provided by the IMF.

First, the contributions from Greece and Ireland have to be subtracted (€19 bn between them), as they themselves are receiving aid and are therefore exempt from contributing. Secondly, to ensure a 'triple A' credit rating – and therefore low borrowing costs – eurozone governments are guaranteeing 120 percent of each bond raised (allowing for a reserve that can never be used).⁹ In addition, as S&P-Analyst Moritz Krämer has pointed out, the share of eurozone governments without a triple A rating must also be discounted, if the triple A rating of the EFSF is to be guaranteed. This means that the real size of the EFSF is €213 billion, with another €60 billion added through the European Stabilisation Fund. Importantly, under the agreement struck in May, the IMF would only add 50 percent of the sum the EU provides, meaning €136 billion as opposed to the original €250 billion, leaving a total of €409 billion.

This should be weighed against the potential cost of bailing out several eurozone economies. According to a Goldman Sachs estimate, taking Ireland, Portugal and Spain out of the bond markets for two years will cost €450 billion.¹⁰ Others put the figure higher, with Cornelia Meyer, CEO at MRL Corporation, predicting that a Spanish bailout alone is likely to cost up to €500 billion.¹¹

2. How will the permanent eurozone crisis fund work?

EU leaders are likely to focus their energy on trying to agree to a limited Treaty change in order to allow for a permanent rescue mechanism to replace the EFSF by 2013. Details on how this mechanism will actually work are likely to be agreed next year.

The draft conclusions of the Council meeting propose adding the following amendment to the Lisbon Treaty:

“Member states whose currency is the euro may establish amongst themselves a stability mechanism to safeguard the stability of the euro area as a whole. The granting of financial assistance under the mechanism will be made subject to strict conditions.”

The German government has stated that it will seek a stronger clause, making it clear that any aid would come with strict budgetary conditions. A spokesman said, “From our perspective, a formulation which makes the connection between financial aid and the requirements for budget consolidation much clearer is desirable”¹².

EU finance ministers have previously agreed the basic workings of what has been called the European Stability Mechanism (ESM). In the event of a crisis, as a first step, Eurozone finance ministers will decide by unanimity whether a eurozone country has liquidity problems. If so, the country could be given short-term credit lines with strict conditions, rather than full scale bail-outs stretching over a number of years.

⁹ See the statute of the EFSF, http://www.efsf.europa.eu/attachments/efsf_framework_agreement_en.pdf

¹⁰ Cited in <http://ftalphaville.ft.com/blog/2010/12/10/433426/what-a-difference-an-efsf-year-makes/>

¹¹ Cited in <http://www.openeurope.org.uk/media-centre/summary.aspx?id=1242>

¹² *Handelsblatt*, 14 December 2010; <http://www.wirtschaftspresse.biz/psepp/fn/pcc/sfn/showedetail/DocID/1124466/EditionID/4/SectionID/2/P ageID/1124453/pDay/14.12.2010%2000:00:00/showtyp/1/SH/479c02c220c92ccddb4a38221df70f/index.html>

The second step would then see the IMF, the ECB and the European Commission deciding whether the country in question is also insolvent. In that case, the country could be required to enter negotiations with its creditors to seek a restructuring of its debts. To this end, "collective action clauses" will be annexed to all eurozone government bonds issued after June 2013. No limits have yet been set on the funds that could be provided under the ESM. The draft conclusions only state:

"If debt sustainability can be reached through these measures, the ESM may provide liquidity assistance."

Non-eurozone countries will be "associated" with the plans, with voluntary contributions from Britain, Denmark and Sweden remaining a possibility.¹³ In principle, involving private creditors and allowing for restructuring would transfer more risks from taxpayers to creditors and fiscally irresponsible governments – where the risk belongs. It would also provide creditors with clearer (and more predictable) rights and timetables in cases of restructuring.

But EU leaders have a daunting task in trying to decide how this proposal will work in practice and huge uncertainties remain. For example, how strict can the conditions imposed on lending countries realistically be? Will the new debt issued with collective action clauses be cheaper than the existing stock of debt and what will that mean for the market?

Eurozone leaders remained trapped in a Catch 22 situation. The lending countries, most importantly Germany, can only sell a de facto debt union to their electorates if it comes with strict rules and terms, as reflected in the proposed Treaty change which provides for "strict conditions" to be applied. But such terms imposed from the outside would seriously compromise the ability of the borrowing countries to democratically govern themselves. In addition, the Commission, the IMF and the ECB – none of which are democratically accountable bodies – will now make key decisions on a country's economic future. It is therefore unclear how this mechanism will solve any of the fundamental problems of the eurozone, including the diverging levels of competitiveness within the Single Currency.

3. Is there a future for eurozone bonds?

Although ministers have said that eurozone bonds – or E-bonds – will not be discussed at the Council meeting¹⁴, the idea is gaining ground as a potential 'solution' to the monumental challenge facing the Single Currency. The leader of the eurogroup, Jean-Claude Juncker and Italian Finance Minister Giulio Tremonti recently argued that stability in the eurozone,

"can be achieved by launching E-bonds, or European sovereign bonds, issued by a European Debt Agency (EDA) as successor to the current European Financial Stability Facility. Time is of the essence. The European Council could move as early as this month to create such an agency, with a mandate gradually to reach an amount of outstanding paper equivalent to 40

¹³ Cited in <http://www.openeurope.org.uk/media-centre/summary.aspx?id=1255>

¹⁴ Luxembourg's Foreign Minister Jean Asselborn claimed that the proposal isn't going to be discussed at the EU summit at all, saying "I hope we will never need to talk about euro bonds again," he said. "If we manage to secure the stability of the euro by making clear decisions this week, and I'm sure that the European union is capable of doing this ... then I think we can do it." *Reuters*, 'E-bonds off EU summit agenda – minister', 13 December 2010 <http://uk.reuters.com/article/idUKTRE6BC0Q120101213>

*per cent of the gross domestic product of the European Union and of each member state.*¹⁵

The idea would be to mix national bonds and E-bonds allowing for weaker eurozone economies to piggy back on the strength of Germany, therefore reducing their borrowing costs. While the Commission has labelled the proposal “intellectually appealing”, Angela Merkel and Nicolas Sarkozy have so far rejected it, noting that it would require another series of changes to the EU Treaties.

But the proposal is not going away, with Jean-Claude Juncker noting the difference in tone between Angela Merkel and Finance Minister Wolfgang Schäuble, even claiming that “Wolfgang Schäuble’s consideration of the proposal” was very close to his own position.¹⁶ If the eurozone crisis worsens, more EU leaders could come to see E-bonds as one in a narrowing list of options to save the eurozone from imploding.

But would E-bonds really solve the problem?

The German media and commentators have heaped criticism on the idea of E-bonds over recent weeks. Former ECB Chief Economist Otmar Issing has noted that

“a common eurozone bond would certainly imply that countries like France and Germany would have to pay higher interest rates, and that would in the end mean higher tax burdens for their citizens.”

Issing has also questioned whether E-bonds would actually solve the problem for which they are created, i.e. lowering borrowing costs of eurozone countries which face refinancing difficulties. This is because the rates on the stock of existing, national bonds are likely to increase.¹⁷ As *Handelsblatt*’s economic editor Daniel Goffart points out, this means that

*“the advantage of low interest rates for eurobonds would be destroyed as for the remaining national bonds a lot more would need to be paid. On balance, the financing costs would not decrease.”*¹⁸

The alternative would be for 100 percent of struggling countries’ bonds to be financed through E-bonds. However, that would merely formalise Germany’s position as the paymaster of Europe and amount to a perpetual bail-out. Leaked figures from the German government forecast that eurobonds would push up German borrowing costs by €17 billion annually.¹⁹ This would be hugely problematic to sell to the German electorate.

¹⁵ *FT*, ‘E-bonds would end the crisis’ by Jean-Claude Juncker and Giulio Tremonti, December 5 2010 <http://www.ft.com/cms/s/0/540d41c2-009f-11e0-aa29-00144feab49a.html#axzz180laQ4c0>

¹⁶ As claimed by the *European Primary Dealers Association*, cited in *Reuters*, ‘Analysis: Euro zone bonds idea won’t go away’, 13 December 2010; <http://www.reuters.com/article/idUSTRE6BC0MW20101213?pageNumber=2>

¹⁷ <http://www.europesworld.org/NewEnglish/Home/Article/tabid/191/ArticleType/articleview/ArticleID/21419/Default.aspx>

¹⁸ *Handelsblatt*, ‘Junckers Plan ist teuer und steckt voller Illusionen’, 10 December 2010 <http://www.handelsblatt.com/meinung/kommentar-politik/euro-bonds-junckers-plan-ist-teuer-und-steckt-voller-illusionen:2709128:0>

¹⁹ The estimates forecast that eurobonds would have an interest rate of 3.31 percent. Compared to the current 1.73 per cent interest on German bunds issued worth €1.05 trillion, that would push German borrowing up by €17 billion annually *Irish Times*, ‘Germany hints at conditional eurobond backing’, 13 December 2010 <http://www.irishtimes.com/newspaper/finance/2010/12/13/1224285403970.html> and

In addition, E-bonds would create fresh moral hazard, as they would eliminate the incentive for weaker eurozone governments to be fiscally responsible because they could always fall back on cheaper borrowing guaranteed by the stronger countries. A leader in Frankfurter Allgemeine Zeitung recently argued, "In the European interest, nobody should cross this line."²⁰

It should also be kept in mind that Germany's own public debt is set to rise to 82 percent of GDP by 2013²¹ with the country facing increased borrowing costs itself.

4. Should the ECB continue to finance governments and bail out banks?

Although supposedly technically, legally and politically independent, the eurozone crisis has drawn the European Central Bank into the realm of politics. Its future is likely to be discussed at the summit in some way (although it is not formally on the agenda for obvious reasons). The ECB is likely to come under pressure from countries such as Spain and Italy to expand its purchase of eurozone government bonds to a mass scale in order to stifle the risk of contagion from Ireland and Portugal. This is something which will be strongly resisted by Germany.

The ECB is currently pursuing an increasingly politically and economically unsustainable two-pronged strategy to shore up the eurozone.

Firstly, it is lending to banks who are struggling to fund themselves on the markets, most notably in Ireland, Portugal and Spain, leaving the ECB exposed to a large amount of potentially 'bad' loans. The Eurosystem of eurozone central banks that underpins the ECB is leveraged 25 times²² (while the average hedge fund is only leveraged 3 to 4 times). A fall in assets of only a few percent could wipe out the ECB's reserves, in which case the ECB itself might have to be recapitalised. The ECB could print more euros in order to pay off its losses but this would pose the risk of sparking inflation.

Despite initial ECB plans to withdraw emergency lending to eurozone banks by early next year, ECB President Jean-Claude Trichet has said that it will continue to support struggling banks, which continue to have difficulties in recapitalising.

Besides providing funding to eurozone banks, the ECB has also bought government debt on the secondary markets. The ECB's holdings of eurozone government bonds are currently running at €72 billion, with purchases of €2.7 billion last week – the highest amount since June²³. Trichet has said that the programme will be extended to at least April next year and has so far refused to confirm a limit to the amount of bonds the ECB might buy.²⁴ Some sources have suggested that the ECB will seek

FAZ, '17 Milliarden Mehrkosten durch Euro-Bonds', 13 December 2010

<http://www.faz.net/s/Rub3ADB8A210E754E748F42960CC7349BDF/Doc~E995E5F232F7641ADA2F8D800C6E73AA5~ATpl~Ecommon~Scontent.html>

²⁰ FAZ, 'Die rote Linie', 13 December 2010, page 1.

²¹ MNI, 'Germany FinMin: German Public Debt To Rise To 82%/GDP In 2013', 4 February 2010
<http://imarketnews.com/node/8235>

²² The ECB's Monetary Policy Statistics show that as of 3 December 2010 the Eurosystem had liabilities of €1,924,130m and capital reserves of €78,187m,

²³ ECB, 'Open Market Operations', 13 December 2010;

<http://www.ecb.int/mopo/implement/omo/html/index.en.html>

²⁴ *Telegraph*, 'ECB bows to German veto on mass bond purchases', 3 December 2010;

<http://www.telegraph.co.uk/finance/financetopics/financialcrisis/8177568/ECB-bows-to-German-veto-on-mass-bond-purchases.html>

more capital from eurozone governments in order to cover any losses incurred by its bond buying programme²⁵.

According to Italian bank UniCredit, eurozone members will have to refinance or repay €560bn in 2011 – the largest amount since the launch of the single currency and €45bn more than in 2010. Portugal is particularly at risk since it has to refinance or repay €20bn in debt by the middle of next year²⁶.

Mario Draghi, Governor of the Bank of Italy, has expressed fears that the ECB's bond buying programme risks compromising the bank's mandate to remain independent of fiscal policy. "I'm only too aware that we could easily cross the line and lose everything we have, lose independence, and basically violate the [European Union] treaty," he said²⁷. The program also faces strong German resistance, personified by Axel Weber, the German ECB board member expected to succeed Trichet. It is also the subject of a legal complaint at the German Constitutional Court, claiming that the Greek, Irish and Portuguese bonds that the ECB has bought so far represent an indirect bailout in violation of the EU treaties. From a German point of view, the ECB's current role is unsustainable, but until a more stable solution to the eurozone's problem is found, the Germans may have little choice but to accept that the ECB continue with its interventionist policies, in a similar vein to 'quantitative easing' in the UK.

5. How big will the 2011 EU budget be?

Ahead of the meeting of EU leaders, the European Parliament is likely to approve to a deal similar to that offered by national governments at the last Council meeting, which will see the 2011 EU budget increase by 2.9%²⁸. MEPs had previously demanded a 6.2% rise. The Parliament also demanded to be fully incorporated in negotiations on the EU's multi-year budgets, which decide the amount of money available over periods of between five to ten years. However, it only won a non-binding promise that it will be kept informed about how the talks go.

If the Parliament votes in favour of the 2.9% increase, as expected, the new €126.5 billion budget²⁹ can be put in place before the start of 2011.

²⁵ Reuters, 'ECB eyes seeking capital hike - c.bank sources', 14 December 2010; <http://in.reuters.com/article/id/INIndia-53543820101214?pageNumber=1>

²⁶ FT, 'Push for shake-up of EU rescue facility', 13 December 2010; <http://www.ft.com/cms/s/0/3f925148-062a-11e0-976b-00144feabdc0.html#axzz180C9T6Nd>

²⁷ FT, 'Interview with Mario Draghi: Action on the addicts', 9 December 2010; <http://www.ft.com/cms/s/0/af24be36-03ca-11e0-8c3f-00144feabdc0.html#axzz180Lxko8h>

²⁸ European Parliament press release, 'Parliament to vote on EU budget for 2011', 10 December 2010; <http://www.europarl.europa.eu/en/pressroom/content/20101210IPR08950/html/Parliament-to-vote-on-EU-budget-for-2011>

²⁹ European Parliament press release, 'Budget 2011: figures adopted in Budgets Committee', 8 December 2010; <http://www.europarl.europa.eu/en/pressroom/content/20101206IPR06468/html/Budget-2011-figures-adopted-in-Budgets-Committee>