Euro crisis: A comprehensive response

€750bn: Europe gets serious

ECB to buy bonds

Economic Analysis

Economics | Eurozone
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Finally acting fast and in size

Europe has got the message: in a financial crisis, you need to act fast and in big size to break the negative feedback loops before they bring the economy down. Having dithered almost three months over the safety net for Greece, it took Europe only five days since the outbreak of serious contagion last Tuesday to come up with a strong €750bn safety net for other peripheral countries at risk.

Cash, loan guarantees and an IMF top-up

The major elements of the safety net are:
- €60bn **stabilisation fund** from the EU Commission
- €440bn in **loan guarantees** from Euro member states
- €220-250bn top-up envisaged from the **IMF**

Adding the €110bn for Greece agreed before, the total support for the Euro periphery could amount to €860bn (or $1.1trn). Serious money by any standards.

The package can succeed

€750n could, for instance, cover the likely funding needs of Spain, Portugal and Ireland until the end of 2011 almost thrice over, we believe. We see a very good chance that the package can succeed. The Eurozone has demonstrated a capacity to do what it takes to end its sovereign debt crisis soon, in our view. Of course, the help comes with a snag for the fiscally challenged periphery: Spain and Portugal had to promise further fiscal austerity measures by 18 May. The Eurozone is turning into a much more cohesive fiscal unit, in our view.

ECB buys government bonds + $-swapline with Fed

The ECB and other central banks also took major measures to combat the crisis. In an emergency meeting Sunday night, the **ECB decided to buy government securities and private securities on the secondary market**. The ECB also announced **a 6-month refi operation** with full allotment in May at a rate linked to the main refi rate of 1%. Separately, the Fed will re-open **$-swaplines** with the ECB, the BoJ, the BoE, the BoC and the SNB.

Help for Greece gets moving

The €110bn Eurozone/IMF aid for Greece took two further residual hurdles over the weekend. (1) The IMF Executive Board formally approved the IMF's €30bn part of the 3-year programme on Sunday, voting to disburse €5.5bn immediately, in good time for Greece's €8.5bn bond redemption on 19 May. (2) Germany's Constitutional Court on Saturday rejected a legal challenge against aid to Greece.

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Europe gets serious

Europe has got the message: In a financial crisis, you need to act fast and big to break the negative feedback loops before they bring the economy down. After almost three months of dithering over the safety net for Greece, it took Europe only five days from the outbreak of serious contagion on the afternoon of 4 May to the evening of 9 May to come up with a sizeable safety net for other peripheral countries at risk.

The key elements major elements of the safety net to safeguard funding for beleaguered Eurozone sovereigns such as Spain, Portugal and Ireland are

- €60bn **stabilisation fund** at the EU Commission. Countries in need can draw on this fund instead of having to borrow in the market.
- €440bn in **Eurozone loan guarantees** or bilateral loans for beleaguered sovereigns so that they can borrow in the market at acceptable rates.
- €220-250bn top-up envisaged from the **IMF.**

To some extent, the mix of cash and guarantees resembles some of the earlier post-Lehman bank support programmes (of course, the stabilisation fund provides loans, not equity stakes).

The stabilisation fund will reportedly be funded partly from the EU budget, with the EU Commission issuing bonds under its own name if need be, as the EU Commission had done for its assistance programmes for Emerging Europe in 2008/09.

The help for fiscally challenged Euro members comes with the predictable snag: the Eurozone will move to much tighter fiscal surveillance of member states, including tougher sanctions for countries with excessive deficits. Portugal and Spain had to commit to further deficit reduction, with Portugal scrapping or delaying two major infrastructure programmes including, reportedly, a new airport for Lisbon. We expect the policy changes to go a long way towards making the fiscal position of these countries sustainable. Greece has already gone down this route under its own €110 programme. The Eurozone will become a **much more fiscally coherent unit as a result**, in our view.

Is the money enough for Portugal, Spain and Ireland?

As far as fundamentals are concerned, the amount of money is clearly sufficient, in our view.

Bond redemptions and **coupon payments** for the remainder of 2010 and 2011 will be €10.1bn for Ireland, €21.8bn for Portugal and €89.9bn for Spain, resulting in a total of €121.8bn (see Euro govie issuance primer, 06 May 2010).

More than enough for Spain, Portugal and Ireland

Even if **fiscal deficits** (excluding coupon payments) were as high as of 5% of GDP, this would add €115bn to the funding needs. We expect these three countries to run a smaller deficit than that in 2011.

Assuming in addition that the countries could not roll over all their **short-term bills**, we might arrive at a total funding need of around €300bn for the next 20 months for Spain, Portugal and Ireland taken together.

Whichever way we look at it, the €720-750bn available for **loans, sovereign debt**

guarantees and the **stabilization fund** looks very substantial relative to the potential funding needs of Spain, Portugal and Ireland. This would leave a major amount on the table to partly support the funding needs of, say, Italy, if need be.

However, we do not believe that the entire funding needs for Spain, Portugal and Ireland will have to be covered by the guarantees.

If need be, the response could be scaled up

Also, we believe that Europe and the IMF would probably find it easy to scale up the programme even further if really need be. In other words, we do not expect the money to run out for a long time.

Neither Portugal nor Spain or Ireland are in a fiscal position as precarious as Greece was in late 2009, in our view. For a comparison, see our Fiscal Scorecard, 30 April 2010. Even the most fiscally challenged Greece will be in a sustainable position after its current harsh austerity programme, in our view (see Is Greece sustainable? 21 April 2010).

It stands a very good chance

The programme announced in the early hours of Monday looks very substantial. It should have a very good chance of impressing markets. If not, we would expect Europe to scale it up again. We maintain our key forecasts:

- Neither Greece nor any other Eurozone country will default on its sovereign debt.

A much more coherent Eurozone

- As an end-result of the wrenching crisis, the Eurozone will likely have a more coherent fiscal policy, with much stronger fiscal surveillance. The Eurozone will eventually in better shape than it had been before. With a headstart into the fiscal adjustment that all major Western economies have to face in the near future, the Eurozone will be in a comparatively comfortable position.
- Neither the additional fiscal tightening in the Euro periphery nor the possible setback to confidence in the wake of the current market turmoil will derail the core European economic upswing.

Only limited economic damage

- If Europe manages to calm markets somewhat within four weeks from now, the economic damage for Europe will remain limited. We do not change our above-consensus forecasts for growth in core Europe in 2010 and 2011. However, reflecting the additional fiscal tightening in the periphery, we have reduced our 2010 GDP forecasts for Spain, Portugal and Greece. That takes our call for overall Eurozone GDP for 2010 from 1.7% to 1.4% (see Forecasts at a glance, 07 May 2010).

The big picture

Will the decisions put an end to the Euro crisis? In the extremely volatile market environment, that is impossible to answer. The experience of last week when markets tumbled despite the passage of a €110bn aid programme for Greece may still warrant some caution. But the numbers are staggering enough to suggest a very good chance that it will work, in our view.

The wider context

To assess the current situation, we put it into a **wider context.**

A question of political will

Stopping the euro crisis is ultimately a question of political will, not of economics, in our view. If Europe is ready to do what it takes, it could do so:

1. The **fiscal deficit** of the Eurozone as a whole in 2009 (6.3% of GDP) was smaller than that of the US, Japan or the UK (11.5%). If the Eurozone wanted to act as a unit rather than a bunch of disparate countries, it could bail out any of its members. This would de facto re-distribute the existing deficits within the union temporarily from the weak to the strong until the weak have regained enough fiscal credibility to shoulder their own burdens again.

2. The **European Central Bank (ECB)** is a big central bank presiding over an economy about the size of the US, with an almost balanced current account (we expect a deficit of 0.2% of GDP this year) and a high domestic savings rate with household savings of 15.3% of gross disposable income in 2009. Because of the size of the domestic economy, the inflation-conscious ECB does not need to care much about the exchange rate. If the ECB really wanted to, it could stop any domestic financial panic by injecting as much liquidity as it takes, ideally by buying government bonds in size on the secondary market.

Does the Eurozone want to act as a unit?

The key questions for the Eurozone are thus political:

- Does the Eurozone want to act as a unit or risk being taken apart by a market panic instead?
- And if wants to act as a unit, how bad does the turmoil have to be before it gets its act together?

Closing ranks?

Under duress, the family closes ranks

Our answer to the first question remains that, under duress, the Euro family is much more likely to close ranks than to break apart. We see some evidence for that:

- The sizeable majority in the Greek parliament (172 : 121 votes) last Thursday for one of the most frontloaded fiscal austerity programmes imaginable in the Western world.
- The sizeable majority in the German parliament (391 : 139 votes) last Friday for the German €22.4 bn contribution to a huge €110bn European/IMF bailout for Greece.
- The Euro summit pledge Friday that the group would do "all it takes" to defend the euro.

Yes, the bail-outs are not popular in parts of Europe such as Germany. But how popular were Tarp, Talf and their European equivalents at the time? Of course, there is a tail risk that the will to preserve the results of 60 years of European integration may snap if the crisis escalates further and the sums needed to impress markets get bigger and bigger. But it is a very small risk, not a likelihood, in our view.

Is Europe there yet?

Memories of Lehman are still painfully fresh – that helps to concentrate minds

Partly because there are no established emergency procedures, saving Greece from its creditors has taken so painfully long that contagion has now spread like wildfire across the Euro periphery and into global asset markets. Acting fast does not come easy for a Europe which is better at making grand statements than at sorting out the fine print.

However, memories of the post-Lehman disaster are very fresh. Policy makers are much more aware of the downside of being late than before. It took ECB Trichet 30 hours from his "business as usual" press conference on meltdown Thursday until he diagnosed a "systemic crisis" over dinner with Eurozone leaders last Friday. While not ignoring the tail risks, we expect the Eurozone to get its act together even more impressively within a month from now in case today's news turn out to be not a game changer yet. If need be, we would expect Europe would probably scale up the policy response even further until some response is big enough to work.

France and Germany

The initial response to the Greek crisis was driven a lot by German concerns (late rather than early, tough conditions, all meant to force the periphery into a frontloaded fiscal adjustment. Media reports about the Friday night summit suggest that the new approach will be more driven by France (early response, less tough conditions).

Only a modest role for the IMF

Because IMF funds do not need to go through a separate EU (or German) approval process as long as the IMF has funds available, German chancellor Merkel seems to see IMF funds as the politically easier option for her. However, French president Sarkozy and ECB president Trichet have been less keen on a major role for the IMF, to put it mildly. The end result seems to be a compromise again, with the major role for the Eurozone but a substantial role for the IMF as well.

Ditching taboos one after the other

One **European taboo** after the other seems to go by the wayside. First, the **no bail-out rule**. Now apparently the rule that member states (bilateral loans to Greece) should be in charge, not the EU as such (which happened last night with the stabilisation fund part of the package). Even the ultimate taboo, namely to not monetise government debt by big central bank purchases on the secondary market, was cast aside last night..

Like Lehman?

The self-reinforcing dynamics of the systemic crisis seem, in many respects, similar to 2008. Concerns about impaired bank assets (US subprime and overall mortgages then; euro periphery sovereign debt now) hit the banking system, concerns about the banks caused grave market dislocations, triggering a big recession after Lehman.

Not a replay of the Lehman-subprime disaster, in our view

However, we also see two big differences:

1. In the US subprime/mortgage crisis, the underlying losses were very real, even if the size was highly uncertain. Whether or not there will be any actual losses on Euro periphery sovereign debt is a matter of political will, namely the will of the peripheral countries to make their fiscal positions sustainable (as Greece has largely done, in our view), and the will of the other Euro members to provide any bridge loans needed. If the will is there, there will be no underlying losses (debt restructuring) at all. That has been and remains our forecast.

2. The Western economies were already in stagnation pre-Lehman. Now, they seem to be rebounding vigorously from recession.

All in all, we think that history will not repeat itself here. The chances that the Euro crisis will get resolved faster than the post-Leman crisis was, and that the overall economic damage will be much smaller, still look good to us.

Still one additional line of defence left

We see a very good chance that last night's events will be the game changer. If not, we would expect Europe to up the ante again. If really need be, the last line of defence would still be even more massive buying of sovereign debt by the ECB, akin to the quantitative easing of the US Fed that finally turned the US/global financial crisis around in March 2009.

Aid for Greece gets moving

The €110bn Eurozone/IMF aid for Greece took two further residual hurdles over the weekend:

- The **IMF Executive Board** formally approved the IMF's €30bn part of the 3-year programme on Sunday, voting to disburse €5.5bn immediately, in good time for Greece's €8.5bn bond redemption on 19 May.

- Separately, **Germany's Constitutional Court** threw out a challenge to prevent the flow of German aid to Greece. The court will hear the case in due court but refused to issue an immediate injunction against it, saying that it had no reason to doubt the government's judgement that stopping the aid could have adverse consequences. This may suggest that the court will not rule against aid for Greece in its later proceedings either.

A weekend of drama

European crises often get resolved in late-night sessions in Brussels. But even by European standards, this was a weekend of drama.

- A **Eurozone summit** on Friday evening meant to simply approve the €80bn Eurozone part of the joint Eurozone/IMF aid for Greece turned into a long crisis meeting on how to tackle market turmoil before the open of Asian equity markets on Monday.

- In the early hours of Saturday, the **EU Commission** was asked to come up with more adequate (or ambitious?) proposals.

- Separate phone calls between US president Obama and Germany's chancellor Merkel and French president Sarkozy added to the sense of urgency.

- Upon the start of the finance minister meeting on Sunday late afternoon to decide the safety net for beleaguered Eurozone sovereigns beyond Greece, **German finance minister Schaeuble** suddenly had to be taken to a Brussels hospital due to an adverse reaction to a new medication. Germany's minister of the chancellor's office, de Maziere, had to fly to Brussels immediately to replace him in the crucial negotiations.

- Having just lost a crucial regional election, Germany's Merkel had to call a **late-night emergency session** of her inner cabinet in Berlin to discuss whether the EU proposal for help to Greece would be compatible with the way in which Germany's Constitutional Court may interpret the no bail-out provisions of the EU Treaty. In this respect, Germany then again insisted on a significant role for the IMF. See Setback for Merkel, 10 May 2010 for a discussion of the German regional election.

Eurozone bailouts: The legal basis

How compatible is support for fiscally challenged Eurozone members with the EU Treaty? As economists, we are not legal experts. But we note a few points.

- The Treaty on European Union has an explicit "**no bail-out clause**". Article 125 explicitly states that the Union or any member state “shall not be liable for or assume the commitments of central governments, regional, local or public authorities … of any Member State”.

- The ECB and national central banks are not allowed to help directly either. Article 123 states that “overdraft facilities or any other type of credit facility with the European Central Bank or with (national) central banks in favour of … central governments, regional, local or other public authorities … shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments”.

Difficulties beyond the control of the member states

- However, the Treaty also contains a general clause in Article 122 (2): “Where a Member State is in difficulties or seriously threatened with severe difficulties caused by natural disasters or exceptional occurrences beyond its control, the Council, on a proposal from the Commission, may grant, under certain conditions, Union financial assistance to the Member State concerned.”

If fiscally challenged member countries take at least some steps to tackle their deficits, as Greece has done and Portugal and Spain now seem to be doing, the EU could blame a refusal of investors to fund the governments on disorderly capital markets and thus on circumstances beyond the control of the governments concerned. This seems to be the route which Europe wants to take. History has shown that EU treaties and protocols can be interpreted flexibly, if need be. When Germany first breached the 3% deficit ceiling of the Stability and Growth Pact, it got away with it. In the end, the pact was adjusted to suit political needs

Link to Definitions

Macro

Click here for definitions of commonly used terms.

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