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MACROCOSM

# Agree to Agree… on Wednesday

Monday, October 24, 2011

**Lorcan Roche Kelly**

**Europe fired blanks at the weekend's summit. One more chance for a real shootout.**

In last Monday's report we used the final shootout scene in the spaghetti western *For a Few Dollars More* as an analogy for Sunday's European Summit (see "Six Days to What" October 17, 2011). But as we warned might happen, the cowboys forgot to pack their six-shooters. So we will have a rematch on Wednesday, with everyone fully locked and loaded.

Luckily, Wednesday, October 26 offers another analogy from the Wild West that is useful to us -- it was the day of 1881's gunfight at the O.K. Corral, a defining event in American culture. Expectations are now that Wednesday's summit will be just such a defining event for the Euro area, and for the financial crisis that continues to dominate it. But the gunfight at the O.K. Corral lasted all of 30 seconds, and left only three men dead and three injured. With this gap between fact and folklore firmly in mind, it is worthwhile to go through the various developments in Europe over the weekend to sort the reasonable expectations from the fantasy.

Last week we highlighted three main areas where action is needed (again, see "Six Days to What"). We now have some further idea -- but not much more clarity -- on how these are going to progress.

***Decisive action on Greece***

- We are closer to learning the new higher level for the private sector writedown of Greek debt, adding to the 21% loss announced in July (see "Whatever It Takes" July 22, 2011). As we have expected, a writedown in the region of 50% now seems most likely.
- The weekend summit approved the payment of the €8 billion disbursement to Greece under the first Greek bailout, due since September. This payment is necessary to prevent a disorderly Greek default in the short term. However, Euro area agreement is not enough alone to ensure the payment, the IMF -- as co-funders of the Greek bailout -- also have to give the green light.

***Maximizing the effectiveness of anti-contagion strategies***

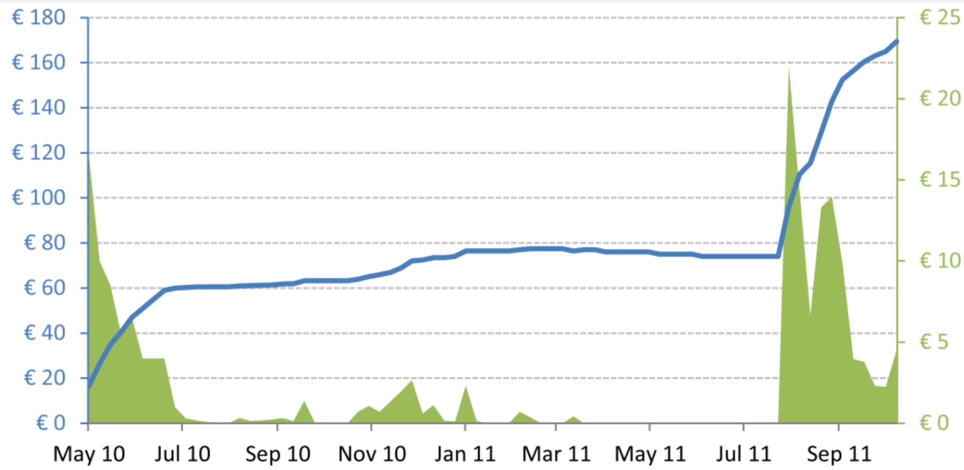
- There is still no clarity on how the maximization of the effectiveness of the European Financial Stability Facility (EFSF) will be achieved.

**Update to strategic view**

**EUROPE MACRO:** Sunday's European summit managed to underwhelm even the lowest of expectations. Agreements to agree were plentiful, but there were no actual agreements, other than the agreement to meet again on Wednesday and to agree the way forward then. Greek default is now expected, and is acting as a positive catalyst in world markets. But markets still hang on an intelligent plan for bank recapitalization and deployment of the EFSF, to rule out contagion. If those expectations can be met and tested, it will be a very positive catalyst.

- [Reports from the summit](#) point to a complex mechanism in which the EFSF will be used as an insurance back-stop for primary sovereign market debt (similar to the role AIG and AMBAC once took with respect to subprime mortgages), and as a special purpose vehicle in the secondary market.
- While a complex EFSF structure may grant the fund more firepower, it is possible that an overly complex mechanism -- and the one suggested certainly is that -- will be less likely to convince the market of its effectiveness. Remember, TARP initially exacerbated the US banking crisis of 2008 because there was so little clarity about how it was to operate (see ["Death by Rescue"](#) November 17, 2008).
- Euro area leaders will request that the ECB continue to use its Securities Markets Programme (SMP) to maintain support of the secondary sovereign bond market. For its part, the ECB has been reducing its bond purchases, with the weekly total not higher than [€5 billion since mid-September](#) (please see the chart below).

**ECB Securities Market Programme bond buys** — **Cumulative** ■ **Weekly**
€ billions




Source: Bloomberg

- Expectations were that the ECB would put the SMP back into hibernation when the enlarged EFSF became active. Any extension of the SMP to allow it to run parallel with the EFSF is certain to reduce sovereign debt contagion, but is unlikely to be popular in Germany.
- Germany's concern with the EFSF continues, with a government MP calling for a [full parliamentary vote on the EFSF](#) for Wednesday, which seems likely to go ahead. While this vote will surely succeed, it does point to German political risk from any perceived potential further exposures from EFSF leverage.

***Bank recapitalization***

- Statements [released after the summit](#) say that there is full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agreement on the need for a coordinated scheme to recapitalize the banks and to improve their funding.

- But full agreement on the need for a solution is not the same as full agreement on the solution. However, the summit has at least provided a figure for the bank recapitalization -- €108 billion. This number is below some market expectations, and -- once further clarity emerges on how it has been calculated -- the market will make its own judgment on whether the number is large enough or not.

In his statement after Sunday's meeting José Manuel Barroso, president of the European Commission, called for more economic integration, more discipline and more convergence in the Euro area to complete the monetary union with an economic union. While we do not expect a fiscal European union to be announced at Wednesday's meeting, we do expect the measures announced to further strengthen ties within the Euro area, and these ties to be another small step towards the fiscal union required for long term stability of the Euro (see "Two-Tier Europe is Born" August 17, 2011).

All in all, Sunday's meeting has given us a progress-report on progress without any actual progress. Wednesday's meeting promises much, but it is important to temper these expectations with the political realities on the ground in the Euro area. Like the gunfight at the O.K. Corral, the reality of the events may be something less than the mythology.

- Tactically, getting more clarity on Greek default will be a positive catalyst. But at this point, it strikes us that this is largely already priced in, including private sector loss-taking that would have been unthinkable a year ago. Markets have come over the last three weeks to the view that we've been expressing for many months -- that Greece itself isn't the central risk to European stability (see "Greece: Suicide, Not Murder" June 7, 2011).
- More important will be coordinated and sensible plans for bank recapitalization and the use of the EFSF, to defend against contagion in the wake of the Greek resolution. If that can be delivered -- and then successfully tested by markets, as we expect -- it will be a positive catalyst.
- But strategically, European integration will proceed only gradually, from crisis to crisis.

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**Bottom line**

Sunday's European summit managed to underwhelm even the lowest of expectations. Agreements to agree were plentiful, but there were no actual agreements, other than the agreement to meet again on Wednesday and to agree the way forward then. Greek default is now expected, and is acting as a positive catalyst in world markets. But markets still hang on an intelligent plan for bank recapitalization and deployment of the EFSF, to rule out contagion. If those expectations can be met and tested, it will be a very positive catalyst.