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MACROCOSM

From the Vacation to the Frying Pan

Tuesday, August 30, 2011
Lorcan Roche Kelly

The second Greek bailout flounders, and politics puts the new EFSF at risk.

Euro area politicians return from their summer vacation this week facing unanticipated challenges to implementing critical rescue proposals from the July summit (see "Whatever It Takes" July 22, 2011). Originally presented as a *fait accompli*, the proposals are now threatened by politics on three fronts: Finland, Germany and Greece.

- The market rally that accompanied Monday's announcement of the merger of two weak Greek banks belies the multiple threats faced by the second Greek bailout package.
- Finnish demands for collateral -- agreed to at the summit -- have led to calls of "me too!" from other Euro area countries. At the moment it is far from certain this can be resolved quickly. Greece does not have -- due to its very ambitious privatization plan -- collateral it is willing to pledge and Finland is still unwilling to climb down on its demands.
- Greece has not helped matters by demanding 90% uptake of the proposed debt swap, the so-called "private sector involvement" (PSI) phase of the second bailout. Greece published its proposals for the PSI, saying that it would not proceed with the debt swap if it did not get the participation required by September 9. This attempt by Greece to play hard-ball might play well at home, but it can only increase the chances of a disorderly default in Greece (see "Greece: Suicide, Not Murder" June 7, 2011). Failure of Greece to implement the -- politically essential -- PSI would mean the abandonment of the entire Greek bailout package by the other Euro area members.
- The expansion of the size and mandate of the European Financial Stability Facility (EFSF) -- which is much more critical for the future of the Euro area -- is now threatened by German politicking.
- The European Central Bank's bond purchases -- under its Securities Market Programme -- which have been very successful in riveting Spanish and Italian 10 year bond yields to 5% over the last three weeks -- is reliant on the successful passage of the legislation to enlarge the EFSF.
- The failure to expand the EFSF, or even any delay, would put the ECB in a very difficult position. Jean-Claude Trichet only re-activated SMP under the duress of market panic, and in reliance on

Update to strategic view

EUROPE MACRO:
European Politicians are back from vacation and must now pass legislation to enact the proposals from the July summit. Arguments over collateral and PSI threaten the passage of the second Greek bailout. But the passage of the EFSF enlargement legislation is critical for the future of the Euro area. It is threatened by Greek concerns, but also by politicking in Germany, the EFSF's key financial and political sponsor. We think the political elite will muddle through and the new EFSF will be enacted -- but while ugly politics play out, markets will continue to flail.

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the belief that an expanded EFSF would come along soon and relieve the ECB of the duty.
- Speaking yesterday to the European Parliament Economic and Monetary Affairs Committee, Trichet emphasized this, saying that the full and timely implementation of the July 21 agreement "is of the essence."

As the largest economy within the Euro area, unequivocal German support for the package is both required, and expected (see "Two-Tier Europe is Born" August 17, 2011). But it now seems that Merkel may have to rely on support from opposition politicians for a successful passage of the required legislation on September 29.

- Merkel's CDU/CSU/FDP coalition has a majority of 40 seats in the Bundestag. Current polls suggest that 23 members of the coalition are set to vote against the EFSF package, which would mean Merkel would have to rely on opposition support to get the package passed. Incidentally, the chart in this morning's *Wall Street Journal* is inaccurate, overcounting Merkel's opposition.
- If Merkel has to rely on opposition support, it is likely that she would have to face a vote of confidence in the parliament.
- If she loses that vote, and the parliament fails to elect a new chancellor, then German President Wulff would dissolve parliament within 21 days and call elections.

While this is a possible outcome -- one that casts a shadow on the prospects for Europe's resolution of the present debt crisis -- we do not view this as a *likely* scenario.

- Elections at this time would not be in the governing parties interest. Support for the CDU/CSU has fallen since the last election, while support for the junior coalition partner, the FDP, has fallen to 5% from 15% at the last election.
- The ruling parties forcing an election now would be like turkeys voting for Thanksgiving.
- Merkel can force the EFSF through by tying the vote on the EFSF to a confidence vote in her leadership. In 2001, then German Chancellor Gerhard Schroeder faced a similar revolt within his governing party on a vote to send German troops to Afghanistan. So he tied the vote to a vote a confidence in his leadership. The dissenters, not wishing for an election, voted in favor of the confidence motion, and thereby also approved the troop deployment.
- While this option would do little to strengthen Merkel's position, it would be better for her than having to endure the ignominy of having to rely on opposition support for passage of the EFSF legislation, and then face a confidence vote anyway.
- The German government has used the Papal visit on September 22-25 as an excuse to postpone the vote -- originally due on September 23 -- until September 29. The extra week should give

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Merkel more time to secure the majority she needs without having to rely on opposition support.

- But Germany is only one of 17 parliaments that need to pass the EFSF package. The latest to come out against the deal is Richard Sulik, leader of Slovakian Freedom and Solidarity (SaS), the junior Slovak government coalition party. He is quoted in *Die Welt* saying that he would "do everything" to stop both the second Greek bailout and the enlargement of the EFSF. The four party Slovak governing coalition's small majority means that it is reliant on support from the SaS to ensure passage of the legislation. Without it, Prime Minister Iveta Radicova would have to rely on support of the opposition Social Democracy party -- by far the largest party in the Slovak parliament -- who may prefer to force an election rather than to support their political opponents.

Successful implementation of *both* major elements of the package -- Greece and EFSF -- would be the best outcome for market stability. But it is the expansion of the EFSF that is essential. The ECB is unhappy with its role as sovereign debt "buyer of last resort," and needs the EFSF to take that role, as outlined at the July summit.

- While a failure to agree on the second Greek bailout puts stress on the market's already jittery nerves, it would not necessarily lead to disorderly Greek default in the short term -- Greece is funded into 2012 under the terms of the first bailout.

But this means it is essential that if the Greek bailout is threatened, the EFSF expansion can still be passed into law *separately* from the Greek bailout. While we are confident political solutions will be found, in the meantime markets will continue to flail. Allowing the expansion of the EFSF to fail, or be delayed, due to concerns over Greece is the most damning case yet of the PIG tail wagging the Euro area dog.

Bottom line

European Politicians are back from vacation and must now pass legislation to enact the proposals from the July summit. Arguments over collateral and PSI threaten the passage of the second Greek bailout. But the passage of the EFSF enlargement legislation is critical for the future of the Euro area. It is threatened by Greek concerns, but also by politicking in Germany, the EFSF's key financial and political sponsor. We think the political elite will muddle through and the new EFSF will be enacted -- but while ugly politics play out, markets will continue to flail.