Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist
John Clinton, Principal

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Lorcan Roche Kelly

It could only happen in Europe -- a summit that strengthens integration loses the UK.

Today European peripheral bond yields are higher, stocks are down and the euro is lower against the dollar. So much for fantasies that last week's summit might have been a definitive answer for Europe's woes. But as we've said so many times, these endless summits are not in fact designed to end Europe's banking and debt crises -- *they are intended to prolong them optimally*, to keep them simmering, to keep the pressure up to drive the nations of Europe into closer political integration under Franco-German dominance (among many, see "QE Nein" November 23, 2011).

European Commissioner for Economic and Financial Affairs Olli Rehn, speaking on November 30, warned that there were ten days to save the euro -- the alternative being the disintegration of the European Union. Now the ten days have passed, and it seems that the euro currency will survive, with pledges of stronger integration and more accountable budget discipline from the 17 nations who use it -- the euro *area*. But ironically, the cost was some degree of disintegration of the European *Union*.

Until last week's summit, the 27-member European Union had been divisible into two major units -- the 17 countries that use the euro currency, and the ten that do not. It now seems that we can further divide ten that do not into those countries that are the United Kingdom and those countries that are not. UK Prime Minister David Cameron -- unhappy with lack of guarantees for UK financial industry, and protection of the single market -- used the UK's veto on treaty changes. This leads to a murky legal situation in which the deal agreed at the summit will be only at an intergovernmental level, not at an EU treaty level.

But before going too deeply into the extra layer of complexity this has added to the already labyrinthine EU structure, let's look at the main points of the agreement reached by the countries in the EU that are not the UK.

- Each government is to adopt a "golden rule" to ensure a primary budget deficit -- that is, a country's structural deficit, not including interest payments on sovereign debt -- of no more than 0.5% of GDP. This rule is expected to be enshrined in primary legislation, that is, on a constitutional basis.

Update to strategic view

EUROPE MACRO, ECB: The political drama of the UK's veto of European Union treaty changes has dominated the headlines about last week's summit. That veto complicates the legal process of implementing the summit's newly agreed steps toward integration, but by no means stops them. That said, those steps, while constructive, are more conceptual than concrete. Most impactful, bondholder loss-taking has been taken off the table as part of the coming European Stability Mechanism, and IMF funding by national central banks looks like it's a go -- subject to Bundesbank meddling.

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- For countries with a debt/GDP ratio of more than 60%, a new benchmark for debt reduction of 1/20 of the excess each year is to be introduced. This will pressure Italy, which would be expected to cut outstanding debt by 3% of GDP next year under this rule.
- There will be stronger central oversight of national budgets, with states that do not adhere to the new guidelines facing automatic sanctions. Yes, the solution for a state that cannot control its budget is to impose fines, only making the situation worse.
- In order to help ensure that this new "fiscal compact" is more effective than the original Stability and Growth Pact -- which utterly failed at keeping the debts and deficits of euro area nations from spinning out of control in the first place -- the sanctions can only be stopped by a qualified majority of governments (not including the nation to be sanctioned).
- Introduction of the replacement for the European Financial Stability Facility (EFSF) -- the European Stability Mechanism (ESM) -- has been brought forward to July 2012.
- Plans to run the EFSF and ESM in parallel have not come to fruition. But Germany's long-standing plans to include private sector involvement (PSI) -- eurospeak for loss-taking by bondholders -- in the ESM have also fallen by the wayside.
- The only hint of a "bazooka" -- the Holy Grail of bailout mechanisms, the one whose very existence will prevent the need for its use -- is the €200 billion new funding to be made available to the IMF. According to a press release from the IMF, €150 billion of this will come from euro area members, with the other €50 billion from non-euro area European Union members that are not the UK (for which we propose a catchy new acronym: NEAEUMTANTUK).
- The IMF statement says that the funds would come "mostly via their national authorities," a reference to the sovereign national central banks that make up the Eurosystem of Central Banks -- who could lend to the IMF on their own account as we outlined previously (see "Saved by an Acronym" November 30, 2011).
- The next summit is to be in March when more progress is expected on the intergovernmental agreement, but decisions on the IMF contributions are due by December 19.
- The decisions on lending to the IMF are already getting some pushback from the Bundesbank, which now may want to get parliamentary approval for any lending it will have to do.

So like many European summit deals before, this one is much heavier on promises to act rather than actual action. But when it comes to satisfaction with summit outcomes, the only audience that matters is the European Central Bank.

- ECB President Mario Draghi's comments after the summit were positive -- he said the deal was "going to be the basis for a good fiscal compact and more discipline in economic policy."
- But he left us in no doubt that the ECB still requires action, rather than promises of action, when he added, "We came to conclusions that will have to be fleshed out more in the coming days."

Contact TrendMacro

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trendmacro.com

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Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

John Clinton
Charlotte NC
704 552 3629
jclinton@trendmacro.com

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- The ECB is still going to avoid large-scale direct intervention into the sovereign debt markets for as long as possible (see "On the ECB Monetary Policy Decisions" December 8, 2011).

Let's come back to the UK's veto -- and what it means and doesn't mean.

- Much of the media coverage -- especially the English language media -- concentrated on Cameron's decision to use the UK's veto to stop any agreement on treaty change at the meeting. While the decision does make good headlines, we are not certain that it will have any lasting negative effect on the integrationist roadmap German Chancellor Angela Merkel and French President Nicholas Sarkozy have laid out for the euro area, of which the UK is not a member in the first place. The UK had made it clear on numerous occasions that they were not interested in joining the single currency, so Cameron's entrenchment of that position should not be a surprise.
- The lack of treaty change means that the treaties that governed the EU before the meeting are still the same treaties that govern it now. Basically, nothing has changed in the structure of the union.
- The UK may be more politically isolated from the union now, but it is only as isolated as it has chosen to be many times before.
- The greatest consequence will be for the City of London as Europe's financial center. Cameron's veto came from frustration that he could not get this summit to focus on his need to protect the City from a series of bureaucratic initiatives that are gradually moving business to Frankfurt and Paris. His undiplomatic gesture may only accelerate those initiatives. He may find that the City of London needs Europe more than Europe needs the City of London.

The fiscal compact agreed at the summit means that the rest of the EU, and particularly the euro area, can continue to move forward on the path towards fiscal integration. However, it will continue to be a slow path. There are bazookas that can be fired to help solve Europe's *banking* crisis, and Draghi has not been slow in pulling the trigger there when he has felt it necessary (again, see "On the ECB Monetary Policy Decisions"). But the euro area's *fiscal* crisis -- which is at heart a *political* crisis -- cannot be solved by any bazooka. It will be solved through continued negotiation, and small slow steps on the road to a federal Europe.

Bottom line

The political drama of the UK's veto of European Union treaty changes has dominated the headlines about last week's summit. That veto complicates the legal process of implementing the summit's newly agreed steps toward integration, but by no means stops them. That said, those steps, while constructive, are more conceptual than concrete. Most impactful, bondholder loss-taking has been taken off the table as part of the coming European Stability Mechanism, and IMF funding by national central banks looks like it's a go, subject to Bundesbank meddling.