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POLITICAL PULSE

For Europe, It's the Politics, Stupid

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Can a clear path to a United States of Europe be coming, with no clarity on Spain's bailout?

The European leaders' two-day summit starting tomorrow is the highest stakes summit for some time. It's not that we expect there to be an announcement that will produce a silver bullet that will magically solve the euro crisis. Rather, this summit is due to produce a roadmap for how the euro area will move from its current dysfunctional iteration to something that will look like a United States of Europe.

Unfortunately, with leaders such as Spain's Rajoy and Italy's Monti worried about more short term concerns -- not least of these being the continued lack of resolution to the subordination issue surrounding the Spanish bank bailout (see "I Love the Smell of Bailouts in the Morning" June 11, 2012) -- it seems that the leaders are not going into the conference with a common purpose. Several contentious and well-publicized statements ahead of the summit already show the gulf between the expected outcomes for different leaders.

Whatever individual agendas the leaders bring to the summit, there is at least a starting point: a report from the President of the European Council, the President of the ECB, the President of the Commission and the President of the Eurogroup that lays out a proposed roadmap. The report, titled "Towards a genuine economic and monetary union." is a to-do list for European leaders. It calls for:

- *An integrated financial framework*. Including a single European banking supervisor and a bank resolution framework coupled with a common deposit guarantee. The proposal is to implement this on a EU27 (all member states) level, but in reality it would probably initially be introduced at a euro area level. The proposal suggests that the deposit guarantee be backed by the European Stability Mechanism (ESM) which is a euro area-only fund.
- *An integrated budgetary framework*. This is a qualitative move towards a fiscal union. This would be coupled with a criteria-based and phased introduction of common debt. Basically, increased pooling of budgetary decisions would lead to greater pooling of risks. Eventually, this would lead to a euro treasury.
- *An integrated economic policy framework*. This is reform on a national level to make economies more homogenous. The type of

Update to strategic view

EUROPE MACRO, EUROPE BONDS, ECB: The upcoming EU summit is not going to produce any silver bullet to solve the crisis in the euro area. But it could be a legitimate roadmap charting an explicit -- if unclear -- course toward a United States of Europe. And it may set policies that will allow the ECB to act to ease pressure on Italy and Spain. In the meantime, ambiguity about the seniority of Spanish bank bailout securities will continue to weigh on markets.

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reform would be along the lines of those already started in the peripheral nations (see "Europe's Supply-Side Revolution" February 17, 2012), and would probably focus on labor markets and services.

- *Strengthening democratic legitimacy*. The proposals for a fiscal union mean that countries will have to cede fiscal sovereignty to the European center. But the democratic institutions in Europe are still mostly at a national level. So in order to give the fiscal union legitimacy, there would have to be more directly elected officials at the European level (today most top European officials are *selected*, not *elected).*

The authors of the report know the magnitude of the task they set out for the politicians, and do not expect much achievement of any of these goals in anything other than the very long term -- five to ten years.

But speaking in an interview with the German magazine *Der Speigel* this week, Germany's Finance Minister Wolfgang Schaeuble said that progress may be more rapid than many expect. He said, recalling the fall of the Berlin wall,

> In the spring of 1989, I had just become the new interior minister in Bonn. The new US ambassador introduced himself to me and predicted that the Wall could come down in the next three years. I replied: "I would have doubted that a few months ago, but now I would say that with a little luck, it'll happen in the next 10 years." And how long did it really take? Less than half a year.

So in looking for outcomes from the summit, proposals -- and that is all they can be at this point -- that match the four areas of integration outlined above will be a positive development, though admittedly not decisive or final. Conversely, if the summit fails to address the proposals, then the gulf between leaders may just be too broad to bridge. Either way, do not expect an early end to the negotiations set in motion this week.

For all the *long-term* goals that the summit may address, there is a *short-term* funding crisis in Spain and Italy, with rising bond yields for both countries reflecting their reduced market access. A ten-year plan for euro area integration is likely to do little to improve them in the short term.

The one institution that can intervene to calm the bond markets -- the ECB -- has, so far, refused to restart the Securities Markets Programme (SMP) under which it buys peripheral debt. ECB President Mario Draghi has said that Europe's problems need political, not monetary solutions. If the politicians agree to start on the road towards those political solutions at this summit, it may give the ECB the excuse to restart the SMP in earnest.

There is no technical reason why the SMP cannot be restarted. The ECB usually takes over €750 billion in overnight deposits at the moment, so has plenty of room to sterilize SMP purchases -- under the current rules any purchases by the SMP have to be met by an equal value of one week deposits.

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Recommended Reading

Target2 and the Euro Crisis
Karl Whelan
Presentation at Bank of England's Centre for Central Banking Studies
June 26, 2012

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So even for countries whose concerns are mostly short-term, there is plenty of reason to agree to a roadmap for long-term reform. Without long-term commitments, the ECB will find it harder to act for the short-term benefit of those under the most pressure. The ECB monetary policy meeting on Thursday July 5 -- at which we expect a rate cut -- will be important, as it will give Mario Draghi a chance to react to the summit, and explain any ECB position changes as a result of it. Hopefully, the summit will produce a clear enough message for him to react to.

But clarity is in short supply on the eve of the summit. One of the biggest concerns in the market continues to be ambiguity of seniority for the securities that will be issued to implement the Spanish bank bailout (again, see "I Love the Smell of Bailouts in the Morning"). Today the Eurogroup made another attempt at explaining how the bank bailout would be funded, and again failed to put the seniority issue to bed.

- The key line from today's statement is: "The financial assistance could be provided by the EFSF until the ESM becomes available, then it would be transferred to the ESM."
- On first reading that seems like a clear case of no subordination. If the funding starts under the EFSF -- without seniority -- then it would not become senior after transfer to the ESM.
- But the use of the word "could" means that the funding may not be agreed in time to use the EFSF.
- So that leaves investors in a race between the start of the ESM and the start of the bailout funding. If the ESM starts first, then the bailout securities have seniority, if the funding starts first, then they do not.
- This is a situation that could be solved with a simple statement. For some reason the Eurogroup refuses to give that statement -- either because it cannot itself agree on the issue, or perhaps because it wishes to keep the matter open as negotiating leverage.

Bottom line

The upcoming EU summit is not going to produce any silver bullet to solve the crisis in the euro area. But it could be a legitimate roadmap charting an explicit -- if unclear -- course toward a United States of Europe. And it may set policies that will allow the ECB to act to ease pressure on Italy and Spain. In the meantime, ambiguity about the seniority of Spanish bank bailout securities will continue to weigh on markets.