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MACROCOSM

Europe, Living on the Edge

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The ECB is paralyzed, the EFSF is sidelined, and tiny Cyprus reveals the system's fragility.

The relief rally following the EU summit has faded -- most notably in the non-program countries of Spain and Italy -- as the markets realize a plan for a program is not the same as a program, and that a non-interventionist central bank can be relied on not to intervene. The European Central Bank resolutely refuses to enter the market -- this morning it announced an 18th straight week of zero bond purchases under the Securities Market Programme. And with the new more powerful EFSF (see "Whatever It Takes" July 22, 2011) still not officially operative, Spain and Italy have come under severe pressure today as the market tests the limit of the ECB's non-intervention.

This morning saw a warning to Euro area policy makers from Cyprus when the Bank of Cyprus -- the island's largest lender -- said that the country may need to some form of bailout. This echoes comments made two weeks ago by Cypriot central bank governor Athanasios Orphanides.

- Cyprus is such a small part of the Euro area -- it accounts for 0.2% of Euro area GDP -- that it is unlikely to pose a threat to the stability of the euro. However, it does provide a clear and alarming example of how vulnerable some Euro area countries are to shocks (see "Dependence Day" July 6, 2011).
- While this vulnerability to shocks could be seen as a Rumsfeldian "known unknown," what is clear is that the Cypriot economy was unable to withstand any shock at all due to the damage it had already incurred from the ongoing financial crisis.
- This is a microcosm of Europe itself -- so this tiny shock from Cyprus can destabilize the whole system -- simply because it exposes how damaged the system already is. A black swan isn't needed when a black feather will do.
- In Cyprus, the feather was the explosion of an Iran-bound arms shipment that was seized two years ago and stored unsafely. The explosion destroyed Cyprus's largest power station, which has led to growth prospects for Cyprus being revised down to zero for 2011. Cyprus was already under pressure -- its banks are heavily exposed to Greece -- and deficit reduction measures do not appear to be working.
- The destruction of the power plant has added to political pressure on the island. The elections in May -- in the non-Turkish controlled

Update to strategic view

EUROPE MACRO, EUROPE BONDS: Cyprus is the latest Euro area country to need a bailout. It's not important to overall Euro area stability, but it shows that for Euro area countries living on the edge, there is no room to deal with unexpected shocks. Spain and Italy have again come under attack, with the ECB unwilling to intervene and the so far unratified new EFSF unable to. However, national central banks are again deploying unconventional tools to combat financial meltdown in the worst affected areas, with Greece now engaging in bond purchases.

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southern half of the island -- did not provide either side of the political divide with a convincing majority. Protests due to the rolling power cuts and the mishandling of the Iran-bound arms forced communist Cypriot President Demetris Christofias to dissolve his cabinet. A new cabinet has not yet been appointed, but both Moody's and Standard & Poor's have pointed to political risks as part of the reason for their recent downgrades of the country.

While we are sure that the difficulties in Cyprus will not add much *quantitatively* to the overall euro area crisis, this black feather highlights how little wiggle room many Euro area countries have.

Bond spreads in the Euro area peripheral non-program countries -- Spain and Italy -- have crept back to their pre Euro summit highs.

- Spain's outlook has not been helped by its president José Luis Rodríguez Zapatero announcing he will bring forward national elections to November 20. This added political uncertainty might prove damaging in the fall, with the government set to be dissolved in late September.
- The political instability in Italy surrounding widely respected finance minister Giulio Tremonti have intensified since we first highlighted them (see "The Sack of Rome" July 13, 2011) with Italian newspaper reports over the weekend speculating that he may be gone soon.

But more fundamentally than either of these two developments, the market's initial positive reaction to the announcements at the summit has been tempered by the reality that the enlargement of the scope of the European Financial Stability Facility (EFSF) will require legislative processes at national parliament level, as we warned (again, see "Whatever It Takes").

Until this process is complete, there will still be no backstop for non-program countries -- critically, Spain and Italy -- other than ECB intervention, which so far has not been forthcoming. With the ECB *refusing* to buy bonds of nations at risk, and the EFSF *unable* to buy, it seems that both Spain and Italy will remain under pressure until September, when ratification of the EFSF is expected. The market has yet to find the level where the ECB will feel compelled to act -- leaving open the possibility that the ECB will *not* act, or if it does, it will be too late.

However, as we recently pointed out, national central banks have a policy tool that they can use *in extremis* -- extraordinary liquidity assistance, or ELA (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011). The Irish central bank has been using ELA for some time, and we anticipated correctly the Greek central bank would be the next to use it (see "On Europe's July Rate Decisions" July 7, 2011).

The latest financial statement from the Bank of Greece seems to point to exactly this, although it is taking a different form than the ELA used by the Central Bank of Ireland. The CBI lists its ELA transactions under the "other

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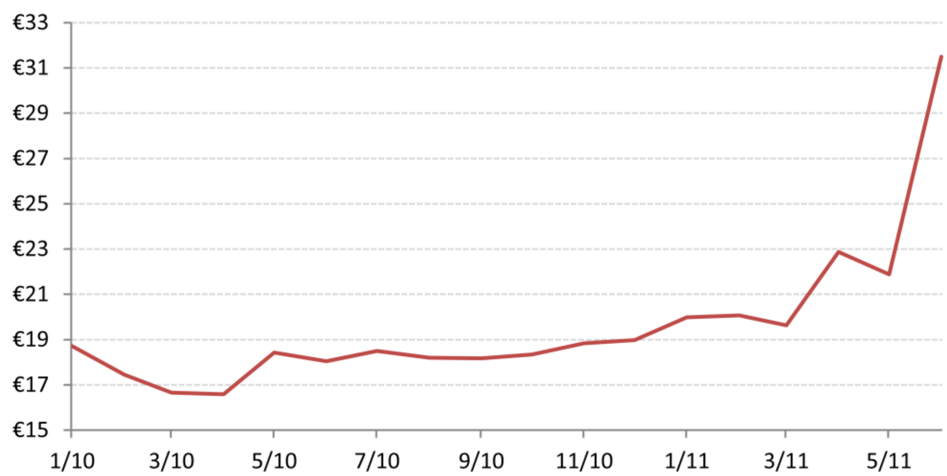
assets" item on its financial statement . The BOG seems to be increasing its holdings of “Other securities of euro area residents denominated in euro” -- item 7.2 on the asset side of its financial statement (see chart below). The securities here are outright purchases by the Bank of Greece -- they are not related to ECB monetary policy. The jump in June of €9.5bn seems to point to what amounts to a miniature SMP in Athens -- ELA in another form.

Bank of Greece, "Other securities of euro area residents" € billions



Source: Bank of Greece

With non-program countries coming under increasing pressure, the ECB will have to step in to calm the markets -- there is no other institution that can do so at this moment. If it fails to act, a situation could arise where Spain or Italy decide to use ELA -- and that would be a game-changer for the Euro area, as money-printing on that scale would not be sustainable, politically or economically.

Bottom line

Cyprus is the latest Euro area country to need a bailout. It's not important to overall Euro area stability, but it shows that for Euro area countries living on the edge, there is no room to deal with unexpected shocks. Spain and Italy have again come under attack, with the ECB unwilling to intervene and the so far unratified new EFSF unable to. However, national central banks are again deploying unconventional tools to combat financial meltdown in the worst affected areas, with Greece now engaging in bond purchases.