
TRENDMACRO LIVE!

On Eurogroup and Draghi in Parliament

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Slightly more clarity on Spain's bank bailout, and a possible dovish turn for the ECB's Draghi.

Yesterday's [Eurogroup meeting](#) provided certainty and uncertainty in equal measure.

The seniority issue on the Spanish bank bailout seems to be finally settled -- again (see "[No Senior Discount for Spain](#)" July 2, 2012). [The statement](#) from the Eurogroup clearly states, "...financial assistance for the recapitalisation of financial institutions for Spain...to be provided via the EFSF until the ESM becomes available and then transferred to the ESM *without gaining seniority status.*" (our emphasis).

- There will be an initial €30 billion made available to Spanish banks after a memorandum of understanding is finalized in another meeting to be held on July 20.
- The funds for Spanish banks will come from the EFSF and be paid through Spain's bank resolution authority FROB (see "[I Love the Smell of Bailouts in the Morning](#)" June 11, 2012).
- The funding will be on 12.5-year to 15-year terms, with cost of funds in line with previous EFSF lending -- expectations are between 3 and 4%.
- When the ESM becomes active and the framework for direct bank recapitalizations is agreed, the ESM will be able to directly lend to the Spanish banks and the FROB intermediary role will no longer be necessary.
- But there is still no clarity on whether ESM bank recapitalizations will [require a sovereign guarantee](#). In the post-meeting press conference, Eurogroup president Jean Claude Juncker said that there would not be any need for sovereign guarantees, while German Finance Minister Wolfgang Schaeuble -- speaking in a separate press conference -- said that he expected final liability of the state would remain. If guarantees are required, then direct loans are not really direct in the ultimate economic sense -- they are just loans to the sovereign.
- In the short run, it seems the Spanish bank bailout announced six weeks ago is nearly resolved, but longer term problems remain.
- Once the July 20 meeting sorts out the details of the bailout, and if those details are no too onerous, the euro area banks will have

Update to strategic view

EUROPE FINANCIAL STOCKS, EUROPE MACRO, ECB: The seniority issue in Spain's bank recapitalization is finally settled -- again. Once other remaining details are ironed out on July 20 -- and assuming feasible terms -- another risk overhang will have been removed. But now the major uncertainty is whether future permanent ESM direct bank loans will require sovereign guarantees, in which case they would not be direct at all. Separately, ECB President Draghi's hints about deflation risk at the European parliament signals welcome easing from the ECB.

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thrown off a major weight that has been holding down their valuations.

- Spain was also granted an extra year to meet its 3% budget deficit target. It now will not have to meet it until the end of 2014.

The Eurogroup promised to discuss some form of debt relief for Ireland. The presumption is that this will just be a technical exercise to transfer some -- or most -- of Ireland's banks' use of central bank ELA (see "[Understanding ELA: Emergency Liquidity Assistance](#)" July 15, 2011) to the EFSF or ESM. This would have the advantage of reducing Ireland's short term financing needs, as it has to pay down the ELA in annual installments under current arrangements.

Aside from short term concerns, yesterday also saw ECB president Mario Draghi [address the European Parliament](#) committee on economic and monetary affairs.

We think it is significant that he referred to the ECB's price stability mandate several times throughout the discussion with members of parliament.

- He said repeatedly that it was a mandate in both directions, *i.e.* it is the ECB's job to protect from both *deflation* and *inflation*.
- This is a refreshing and potentially revolutionary change in the ECB's monomaniacal focus on inflation.
- Perhaps Draghi will use deflationary worries in the future to justify ECB easing action -- which we believe is still necessary (see "[EUicide](#)" April 7, 2011). With yesterday's China CPI coming in at a [surprisingly low 2.2%](#), his concerns may not be misplaced.
- Further, his constant referral to the ECB's narrow mandate as a constraint on the ECB's ability to act may be construed as an invitation to lawmakers to change that mandate.
- This radical idea is not entirely without political support -- French president François Hollande sought a change in the mandate as part of his election campaign. But any change in the mandate would require agreement of all 27 European Union members, so would likely be a very protracted negotiation.

Bottom line

The seniority issue in Spain's bank recapitalization is finally settled -- again. Once other remaining details are ironed out on July 20 -- and assuming feasible terms -- another risk overhang will have been removed. But now the major uncertainty is whether future permanent ESM direct bank loans will require sovereign guarantees, in which case they would not be direct at all. Separately, ECB President Draghi's hints about deflation risk at the European parliament signals welcome easing from the ECB. ▶

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