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MACROCOSM

Bring in the Noise

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After two months of calm, euro area politics are back with a bang.

With protests in Spain, a national strike in Greece, *apparent* attempts to renegotiate the ESM deal and even an uncovered bund auction thrown in for good measure, it seems we are back to crisis as normal for the euro area. We recently warned about the return of noisy high-pressure politics (see "Europe Beyond Draghi's Promised Land" September 13, 2012), and the accompanying uncertainty that it always entails for Europe.

To sort through the noise, let's look at developments in the last 24 hours to see how they have changed the investment landscape.

Protests in Spain ahead of tomorrow's budget announcement are unlikely to derail moves by Prime Minister Rajoy's increasingly unpopular government to implement further budget consolidations.

- The risk that Rajoy would be tempted to slow the reform process due to reduced borrowing costs following recent ECB actions (see "On the September ECB Policy Decision" September 6, 2012) is waning due to what seems today like the end of that rally, and a warning of its reversal. Spanish 10-year yields went back above 6% this morning.
- The higher yields will encourage Rajoy to apply for access to the ESM for a bailout, which would then allow the ECB's new Outright Monetary Transactions (OMT) program to start purchasing Spanish debt to reduce yields at the short end, below 3-year.
- While Spain will likely be the first country to apply to the program, the timing of its application is still uncertain. Rajoy faces regional elections in October, with his native Galicia voting on October 21st. While he would like to wait until after that before asking for a bailout, the timing may be out of his hands if the market continues to pressurize Spanish yields.

Greece, for its part, continues in the seemingly endless cycle of announcing -- but failing to fully implement -- further budgetary and reform measures, while constantly trying to re-negotiate bailout packages, all the time facing protests at home.

Update to strategic view

EUROPE MACRO: As we expected, politics have come back with a bang to the euro area. Spain is under pressure to accept a bailout, and we think timing is the only variable left there. Greece continues to struggle and will likely get more time and possibly more debt writedowns in October. Statements by core finance ministers on the ESM have been misinterpreted as an attempt to unwind previous promises, but the timing of them can be viewed as an exercise in increasing pressure on those hesitating on the road to reform. The dangerous pressure game continues, and with it comes heightened risks.

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- The latest troika report on Greece is due to be completed by mid-October, following the announcement of a further €11.5 billion of cuts to the Greek budget.
- It now seems more likely that Greece may default again before the year is out. The IMF is pushing for more debt relief for Greece, with Greece's European lenders hoping that a term extension -- rather than a principle reduction -- will be enough.
- The IMF is insisting that Greece reaches its target of a debt/GDP ratio of 120% by 2020. Absent a growth miracle in Greece, further writedowns are the only way to achieve that.
- The ECB is still insisting that its approximately €50 billion in Securities Market Programme (SMP) holdings of Greek debt cannot be written down -- as this would be deemed government "financing" -- so the likely first candidate for a haircut would be the bilateral loans given to Greece by the other euro area countries in 2010, with a face value of about €80 billion.
- Writing this debt off would be a politically difficult trick to achieve, but if the IMF plays hard-ball on reducing the stock of Greek debt, it is the most likely candidate for a reduction.
- Discussions on the Greek situation and the latest troika report are due to take place at the EU summit due to be held on October 18-19.

Aside from problems in Spain and Greece, the finance ministers of Finland, the Netherlands and Germany had a meeting yesterday that served to further turn up the noise level.

- The press release following their meeting has been interpreted by some as an attempt to unwind promises made at the June summit with regards to how the ESM will work, and possibly putting the Spanish bank bailout and any renegotiation of Ireland's banking debt at risk.
- *We strongly view this as a misinterpretation of the joint statement.*
- The critical point in the statement regards ESM direct bank recapitalizations. The three finance ministers say that they can only agree to direct recapitalizations after a euro-area banking supervisor is up and running. Further, at such time, they say they will not agree to recapitalizations to deal with "legacy assets."
- This does not risk the Spanish bank bailout -- details of which are due to be announced on Friday -- as that is not a direct recapitalization of Spanish banks by the ESM. That recapitalization made initially by the EFSF, is lending to the Spanish government, not directly to the Spanish banks (see page 17 of today's ESM investor presentation for an illustration of how it will work).
- In Ireland, the bank bailouts have already occurred, so the need for future bank recapitalization is reduced. The problem for Ireland is dealing with some of the instruments it created to allow that recapitalization to occur -- specifically the promissory notes written to bail out Anglo Irish Bank. But again, negotiations on these issues will not be derailed by the position taken by the three finance ministers. The bank debt in Ireland is now state debt.

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- Further, any relief for Ireland would more likely come from either the ECB -- through reclassification of ELA (see "Understanding ELA: Emergency Liquidity Assistance" July 15, 2011) -- or from eurogroup action on current EFSM/EFSF lending to Ireland.
- For the future, the finance ministers' statement means that if their argument holds -- remember these are only the thoughts of three of the 17 eurogroup finance ministers -- direct recapitalizations can only address *future* shocks. The existing problems currently sitting on euro area bank balance sheets will not be addressed by ESM direct recapitalizations.
- However, even if the three finance ministers do win the argument on direct recapitalizations, the current bailout process -- such as the current Spanish deal -- can continue. The money will still come from the ESM, and go to the banks -- it just will have to continue to be via the state.
- Ultimately, the three finance ministers have simply done again what European politicians seem to always do: maximize their power and discretion -- and minimize certainty -- by setting ambiguous terms that can be interpreted any way they wish.
- There may be some significance to the absence of France from this group of finance ministers. During the height of the crisis last year, it was the Franco-German "Merkozy" alliance that drove euro area policy (see "Two-Tier Europe is Born" August 17, 2011). This is potentially a clue that France will not be such a reliable German partner. We have already highlighted Germany's increasingly isolated position (see "Nein! Well, Maybe" May 29, 2012). If this continues, it could be a very important new dynamic in the ongoing crisis.

A mere two days ago -- a long time in European politics -- European Council President Herman Van Rompuy warned that the sense of urgency on the euro may be lost. He understands that, as we have long argued, the only way Europe will move forward on the path towards continued integration and reform is through the application of pressure (see, among many, "A Spaniard in the Works" April 11, 2012). This pressure is as uncomfortable for markets as it is for the politicians. However the absence of that pressure leads to the very thing that Van Rompuy warns against -- complacency. Throughout the crisis the euro area has managed to maintain the pressure at a level that forces things to get done, but without pushing the euro area past a tipping point that would lead to disintegration. But, as always with this strategy the risks are very high.

We will continue to watch developments very closely for signs of too much strain over the coming weeks, but for the moment worries of disintegration should not be too high in investors' minds.

Bottom line

As we expected, politics have come back with a bang to the euro area. Spain is under pressure to accept a bailout, and we think timing is the only variable left there. Greece continues to struggle and will likely get more time and possibly more debt writedowns in October. Statements by core finance ministers on the ESM have been misinterpreted as an attempt to unwind previous promises, but the timing of them can be viewed as an exercise in increasing pressure on those hesitating on the road to reform. The dangerous pressure game continues, and with it comes heightened risks.