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MACROCOSM

Calm Becomes Complacency

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The heat is off, and reform slows to a crawl. Has Draghi done his job too well?

The failure of the eurogroup to agree last night on the next step forward for Greece -- even if the delay is only temporary -- does point to a worrying development in the euro area: complacency. Even more worrying has been the market reaction to the eurogroup's failure. Early weakness in the euro currency did not last to lunchtime, with markets generally taking the latest failure as a non-event.

This complacency from both policy-makers and markets could be seen as a sign that the euro area problems are fixed, and that the euro crisis can safely be consigned to the history books. Yes, but only to a point. That would be counting chickens long before reform eggs have hatched.

True, Mario Draghi's verbal interventions (see "The Phony Bailout" October 12, 2012) have, quite rightly, finally put paid to the *existential* crisis that has faced the euro area over the last two years. But the *existential* crisis of the currency was never the full story. The euro area remains an unfinished project begun decades before the euro was conceived, with the next round of meetings aimed at producing a genuine economic and monetary union due to begin December 13.

But, if the *existential* crisis has passed, and if that removes the essential ingredient of market pressure from these negotiations, their outcome is likely to be far from optimal. Of the four proposed integration strands -- banking, fiscal, political and democratic -- the banking union seems to be both the easiest and least controversial. But even that is already coming under pressure from Germany because it gives too much power to the European Central Bank.

This does not bode well for the success of negotiations on the much larger and more contentious issues that need to be resolved. The three other strands of the integration process demand that countries effectively give up sovereignty. Throughout the process, countries have only been willing to do that under extreme market pressure (see, among many, "Crunch Time for Reform in Europe" March 28, 2012).

If reform progress is suffering from complacency at the euro area level, it has -- in some cases -- ground to a halt at the national level. Mario Monti's

Update to strategic view

EUROPE MACRO, EUROPE BONDS: Complacency has set in. The achievements of ECB President Mario Draghi in taking the existential crisis for the euro area off the table seem to have led euro area leaders to slow their crisis response -- reflected in last night's decision to delay a final decision on Greece. At the national level, the problem is worse. Without market discipline coming to bear, particularly in France, the reform agenda risks getting derailed. We reiterate our short France long Spain call.

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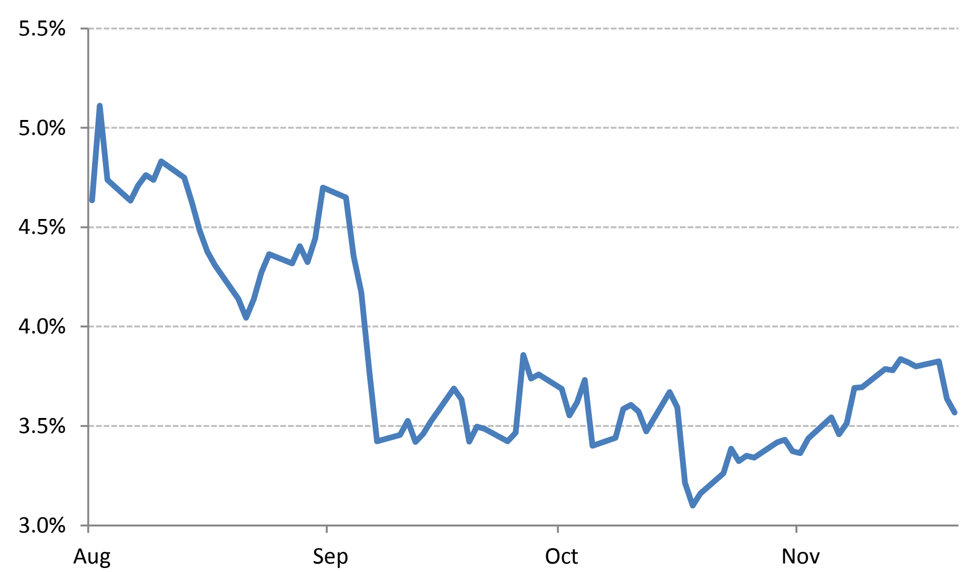
room for maneuver in Italy is seriously curtailed by the elections due by April next. Spain has slowed reform progress, insisting that it should be allowed access to the ESM and the ECB's Outright Monetary Transactions based on the steps it has already taken. In both cases there are mitigating factors. If Monti remains as Italian prime minister after the April election, which is still a possibility, and if (when) Spain does get an ESM/ECB bailout, reform should continue.

France, on the other hand, is a country without a reform *program*, let alone reform *progress*. Socialist President François Hollande, with the backing of a socialist majority in parliament, seems unlikely to be able to tackle structural reforms needed in the French economy, particularly labor market reform. Even suggesting a change to France's 35-hour work week recently was enough to force Prime Minister Ayrault into an embarrassing climb-down, forced by members of his own socialist party in parliament.

We have warned before that France (see "Exceptional Measures" August 29, 2012) was the lucky recipient of overflow safe haven demand, and, more recently (see "Calm Breaks Out in Europe" October 31, 2012) that it is looking more peripheral.

- We're not especially moved by Moody's downgrade of France on Monday, made for reasons that have more to do with France's role in possible future bailouts, and less to do with France itself. We are focusing more on the change in *relative* growth and debt dynamics of euro area countries, and the opportunities those changes make available. We still think that right now in the euro area, the best play is a France-Spain pair trade, long Spanish debt, short French (please see chart below).
- The failure of France to introduce meaningful reforms, and the improvement of Spanish debt following an ESM/ECB OMT program, point to the yield spread only tightening from here.

10-year yield spread, Spain minus France



Source: Bloomberg, TrendMacro calculations

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Recommended Reading

The best films show business at its worst
Luke Johnson
Financial Times
November 20, 2012

And the Fair Land
Wall street Journal
November 21, 2012

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- The potential *relative* improvement of the Spanish economy can be seen in today's decision of the French car manufacturer Renault to increase production in Spain rather than in France, after Spanish unions agreed to wage increases to 2016 at *half* the rate of inflation.

Bottom line

Complacency has set in. The achievements of ECB President Mario Draghi in taking the existential crisis for the euro area off the table seem to have led euro area leaders to slow their crisis response -- reflected in last night's decision to delay a final decision on Greece. At the national level, the problem is worse. Without market discipline coming to bear, particularly in France, the reform agenda risks getting derailed. We reiterate our short France long Spain call.