Quilter

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European Union Summit

Quilter

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>> European Union (EU) leaders met on 8 and 9 December in the latest effort to address the sovereign debt crisis and reached an agreement on new measures designed to restore confidence in the euro.

What steps were taken towards fiscal union?

Provisional agreement was reached on enhancing budget discipline within the EU, in a so-called 'fiscal compact'. Essentially, they are just strengthening the old Growth and Stability pact, and making its enforcement more automatic.

Exact details will be agreed in due course but balanced budget amendments will be introduced into national constitutions and countries that run deficits of more than 3% of GDP will face sanctions. These sanctions will be more automatic than in the past because of a change on the voting rules, making it harder to block them. Closer monitoring of national budgets and debt issuance plans will also likely take place but the EU will not have the power to impose changes to national spending plans.

Who signed up to these changes?

Pretty much everyone signed up to the deal, including all eurozone members, but it will not cover all 27 European Union countries. This is mainly because the UK declined to be involved, citing the lack of safeguards for the financial services industry and the loss of sovereignty that the new measures would involve.

The Czechs and the Swedes, who are outside the euro, may sign up once their national parliaments have been consulted. Hungary will also consult on the measures but is more likely to remain outside the agreement.

The fact that this is not a change to the EU-wide treaty, but just an inter-governmental pact, means that the accord can potentially be implemented quite swiftly. Referendums are unlikely to be necessary but there remains some uncertainty about this.

What about changes to the bailout funds?

No changes were made to the European Financial Stability Facility (EFSF), which eurozone states still intend to leverage up if possible. However, its intended successor, the European Stability Mechanism (ESM) will come into force earlier than expected, probably in July 2012.

In theory, this should mean more cash on the table for possible bailouts but the combined ceiling will remain at €500bn for the time-being, i.e. the intended size of the ESM. However, this will be reassessed in March, according to the press release. Markets have worried for some time that the resources would not be sufficient to cover any necessary bailout of Italy and Spain.

Changes are being made to the terms of the ESM itself, which are quite market friendly. First, voting procedures will be amended to make it easier to reach agreement on deploying its resources. Second, the potential for the private sector to lose money on bond holdings in the event of bailouts will be reduced, although not entirely eliminated.

Is there any new money on the table at all?

EU member states are considering providing €200bn to the International Monetary Fund, in the form of bilateral loans from national central banks. This could then be used to fund future bailouts of struggling eurozone countries. They are expected to decide on this within ten days.

This does sound like they are just giving money to the IMF to give back to other member states but it is hoped that other countries (e.g. the US and the BRICs -Brazil, Russia, India and China) will in some way match these funds to bolster the resources of the IMF. This is by no means certain, of course. It also allows the European national central banks to get round the rules on not directly funding government borrowing, instead using the IMF as a conduit.

What about the European Central Bank?

The European Central Bank (ECB) has been crucial in supporting the Italian and Spanish bond market recently and it had been hoped that they would step up their purchases after the summit. Mario Draghi, the ECB President, played down the likelihood of this yesterday, although he has subsequently welcomed the 'fiscal compact'.

The ECB cut interest rates again yesterday and increased its ability to provide funds to struggling eurozone banks but remains very protective of its independence.

How have markets reacted?

The market response today has been fairly muted, although European equity markets are rallying. Italian and Spanish 10 year bond yields have risen slightly to 6.52% and 5.86% respectively, signalling a modest increase in concern amongst bond investors. However, these yields had already risen sharply yesterday after the ECB downplayed the likelihood of further intervention. 10 year Gilts are slightly weaker at 2.16% while the euro has rallied against the US dollar.

Where does this leave us?

The conclusion from this summit is probably the same as from all the other ones. The eurozone is moving slowly towards fiscal union and the rules will doubtless evolve over time. Eurobonds remain off the agenda for now but may ultimately be needed to end the crisis while the size of the bailout vehicles will probably have to be increased as well. The European Central Bank will help to support the banking sector and will try to prevent Italian and Spanish borrowing costs from rising too high but is unlikely to go much further than that at the moment.

Volatility will continue for some time, not least because the eurozone looks like it is heading for a recession that will make reducing deficits even harder. There is also a massive amount of sovereign and financial debt maturing next year which will need refinancing. The reaction of the rating agencies, particularly S&P who have threatened to downgrade most of the eurozone countries, could also soon lead to more pressure on the single currency.

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