



Perspectives

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The EU's leaders need to plan for an orderly break-up of the euro

Introduction

Much was made in the British media of PM David Cameron's veto at last week's EU Summit (8-9 December). Cameron had stipulated that relatively modest safeguards for the City of London should be enshrined in the treaty; he was not asking for the repatriation of powers or financial regulations.¹ However, the other EU leaders declined to support him and he vetoed the proposed EU27 treaty. The EU17-plus-six (Denmark, Poland, Latvia, Lithuania, Romania and Bulgaria) then agreed to press ahead with an intergovernmental treaty, supported by the three remaining EU countries (Sweden, the Czech Republic and Hungary).² Britain does not however seem to be totally isolated in this endeavour; it will have observer status at the talks over the new treaty.

European Council President Herman Van Rompuy sent a draft of the new treaty to EU leaders on 16 December and plans to have a final version by the end of January for signing in March.³ The treaty will be introduced if a minimum of nine of the 17 Eurozone countries participating in it ratify it. It will be interesting to note how the ratification procedures develop as doubts are being expressed



about the treaty in some Eurozone countries including Ireland, Finland and the Netherlands.⁴

The Prime Minister's concerns over the City were preceded earlier in that week by the release of a report on financial regulation by Open Europe.⁵ This report concluded that "regulation is now less geared to financial services growth but more towards curtailing financial market activity, irrespective of whether such activity is good or bad". There were 49 new EU regulatory proposals potentially affecting the City either in the pipeline or being discussed at EU-level, with very few aimed at promoting financial services trade. The UK was moreover already losing influence on the legislative agenda. Tellingly, this was happening at a time when opportunities in EU markets were limited whilst global opportunities were "exploding".

The agreement

The provisional agreement made by the EU26 at the Summit included a “fiscal compact” (or “fiscal stability union”) along with strengthened economic policy coordination:⁶

- General government budgets shall be balanced or in surplus. This principle shall be considered respected if the annual structural deficit does not exceed 0.5% of GDP. This principle, the “balanced budget rule”, to be introduced in member states’ national legal systems.
- Countries should keep their deficits below 3% of GDP and government debt should be below or sufficiently declining towards 60% of GDP. This is the rehashed Stability and Growth Pact.
- “Automatic consequences” for countries whose public deficit exceeds 3% of GDP, unless a qualified majority decides otherwise. Fines (up to 0.2% of GDP), that can be imposed for breach of the rules.
- A requirement for the member states in “Excessive Deficit Procedure” to submit their national budgets to the European Commission, which will have the power to request that they be revised. In other words miscreant member states will be subjected to close budgetary surveillance and control.

It is important to note that this is not fiscal union, involving a common EU Treasury for determining tax and spending decisions, shared sovereign debt and a fiscal transfer union. But nevertheless Mrs Merkel has said that the EU17 have set themselves on an “irreversible course towards fiscal union”, even though it may take years

to reach that goal.⁷ The Eurozone does not have years.

In addition to the new fiscal compact there was the development of stabilisation tools to cope with “short term challenges”:

- The permanent rescue fund, the European Stability Mechanism (ESM), which is planned to enter into force in July 2012. This has been brought forward from 2013. The adequacy of the €500bn of ESM funding will be reassessed in March 2012.
- The ESM will replace the European Financial Stability Facility (EFSF), taking over from the EFSF in mid-2013. Proposals to let the EFSF and the ESM to stand together with a joint lending power of €940bn were rejected by Mrs Merkel.
- The EU17, other EU countries and non-EU countries to consider the provision of up to €200bn for the IMF to ensure that the IMF has adequate resources to deal with the Eurozone crisis. This would be in the form of bilateral loans drawn on the reserves of the central banks. It was reported that €150bn was to come from Eurozone countries. Prospects of a rapid application of this plan have receded since the Summit after the Bundesbank, for example, set tough conditions before making contributions.⁸ The UK and the US have both announced they will not contribute.⁹

It had been widely expected in the markets that EU17 agreement to the fiscal compact would enable the European Central Bank (ECB) to buy large quantities of sovereign debt. The markets were however running ahead of reality. ECB President Mario Draghi, in his news conference of 8 December, was emphatic that such activity was outside the remit of the bank.

Incidentally, Draghi had just announced at the same conference the cut in the ECB's key rate from 1.25% to 1%, thus fully reversing the increases earlier this year. He also announced that the ECB would adopt further non-standard measures in its continued efforts to support the liquidity situation of euro area banks, following the coordinated central bank action on 30 November 2011 to provide liquidity to the global financial system.¹⁰ The European banking system is experiencing a severe credit crunch.¹¹ The ECB's measures were intended "to ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market".¹² The ECB was therefore prepared to act as lender of last resort to banks – but not to governments.

There were suggestions that the banks, replete with liquidity, could then buy sovereign debt. But shareholders could object and such actions would make the banks even more vulnerable to sovereign debt default than they already are. It has been reported that European banks, wary of the sovereign debt market, are unenthusiastic.¹³

Assessment of the Summit's agreement

The overall assessment in the British commentariat and financial markets was that the Summit fell well short of what was needed to end the Eurozone crisis and little of true significance and consequence was achieved.^{14,15} There is no reason to believe the Eurozone is any nearer to resolving Europe's rolling series of debt crises now than before the Summit. It was therefore widely judged to be a failure.

What is needed to end the crisis is full fiscal union, as we have discussed before, with a central bank that can act as a lender of last resort to governments.¹⁶ But Germany in particular still gives the impression that, providing everyone sticks to Germanic standards of fiscal rectitude, a monetary union of fiscally sovereign nations is still possible. And Mrs Merkel, constrained by the rulings of the German Constitutional Court, has not eased her opposition to debt mutualisation and/or more extensive ECB intervention.¹⁷

Standard and Poor's recent threat (5 December) to review the current ratings of 15 Eurozone countries added to the uncertainty. Greece, at rock bottom, and Cyprus, already under review, were omitted. Even the six Triple-A countries were challenged with the five top-rated countries (Austria, Finland, Germany, Luxembourg and the Netherlands) possibly being downgraded one notch, whilst France might go down by two notches. Fitch's issued warnings on 16 December.¹⁸ The markets could well attack a peripheral state's debt in coming weeks, particularly if a rating

agency provides an excuse by way of a downgrade. The ECB's resolve not to operate large sovereign bond purchases would then be tested. Ominously Italy's funding costs reached a euro era high last week (14 December) with Italy paying nearly 6.5% on 5-year paper.

Economic downgrades

ECB President Draghi's Statement on 8 December also contained a downbeat assessment of the Eurozone economy.¹⁹ The key passage was:

- ... "macroeconomic projections for the euro area...foresee annual real GDP growth in a range between 1.5% and 1.7% in 2011, between -0.4% and 1.0% in 2012 and between 0.3% and 2.3% in 2013. Compared with the September 2011...projections, there is a narrowing of the range of the real GDP growth projection for 2011 and a significant downward revision of the range for 2012. These revisions mainly reflect the impact on domestic demand of weaker confidence and worsening financing conditions, stemming from the heightened uncertainty related to the sovereign debt crisis, as well as downward revisions of foreign demand."

So, interestingly, the ECB is attributing some of the weakening to the Eurozone crisis. Such a sentiment was recently echoed by Spencer Dale, the Bank of England's Chief Economist:²⁰

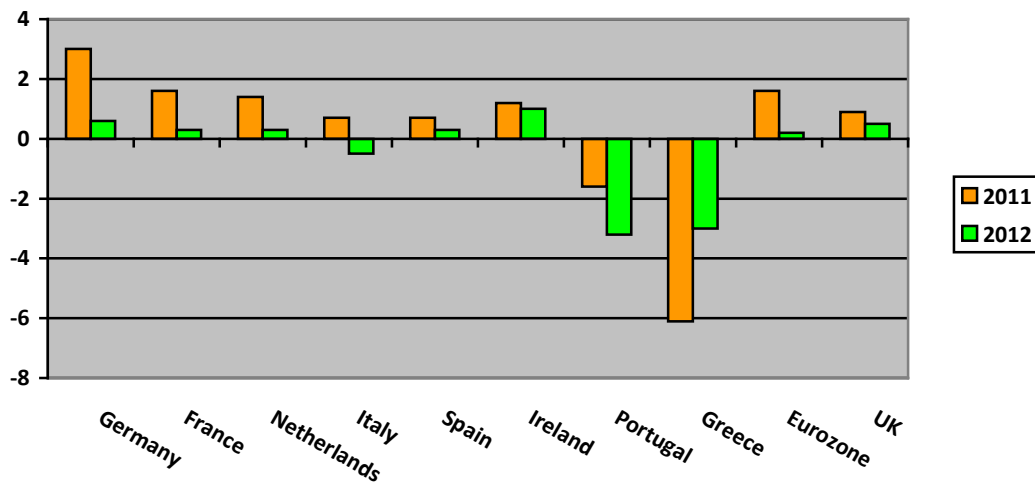
- "Although the euro crisis might not account for the weakness evident over much of the past year, I do fear that the dark cloud hanging over the other side of the channel is casting a growing shadow over our economy. Although the precise reasons why the

economy appears to have slowed are uncertain, and we can't rule out some intensification of domestic headwinds, the most likely explanation would seem to be the growing fallout from the euro area as it has lurched from one mini crisis to another."

The OECD has also downgraded its forecasts for the Eurozone recently.²¹ They now expect only 0.2% GDP growth for the area in 2012, with Germany, France and the Netherlands all showing poor growth. Spain will struggle to grow whilst Ireland's growth, supported by a competitive export sector, could be better than Spain's, though this has to be questioned given the poor 2011Q3 GDP figure (which showed a fall of 1.9%). Italy is projected to be in recession and the prospects are dire for Portugal and Greece. Suffice to say, the weaker southern countries, facing a triple whammy of recession, austerity and a prolonged lack of competitiveness, are no more supported now than they were prior to the recent Summit's agreement. The EU is rapidly becoming an "austerity zone" with tough fiscal rectitude dragging growth down. The key figures are shown in chart 1.

The OECD also downgraded Britain's growth forecasts, projecting negative growth in 2011Q4 (-0.1%) and 2012Q1 (-0.6%). GDP is expected to rise by just 0.5% in 2012 after 0.9% this year. The UK will struggle to recover given the on-going damage to confidence and export markets originating in the Eurozone.²²

Chart 1 OECD, GDP growth, YOY (%): Eurozone countries & UK



Source: OECD, *Economic Outlook, no 90*, preliminary version, statistical annex, November 2011.

Charts 2a and 2b underline how thoroughly dysfunctional and unsustainable the Eurozone is as an economic and monetary union. Even though Germany and the Netherlands are likely to grow only slowly over the next couple of years, their unemployment rates are relatively low and their current account surpluses strong. The southern countries, especially Spain, Greece and Portugal (and Ireland), have horrendous unemployment rates. Greek and Portuguese current account balances are unsustainable whilst Spain and Italy are carrying large external deficits. The German-inspired rescue plan, as agreed at the December Summit, is disastrously unbalanced towards austerity and adjustment by deficit countries instead of growth and adjustment by surplus countries.

France also exhibits high unemployment and a not insignificant current account deficit. Please note that the OECD projects Britain's external balance to be "in balance" in 2012.

Chart 2a OECD, unemployment rates (%): Eurozone countries & UK

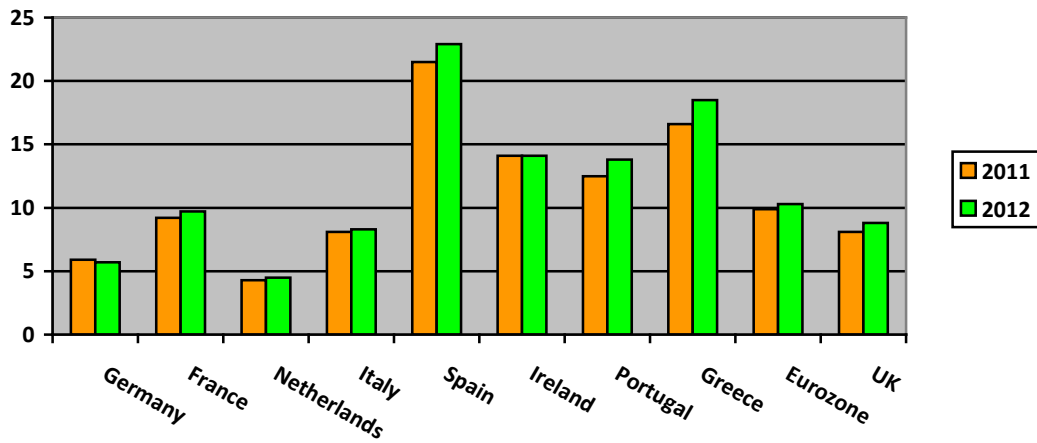
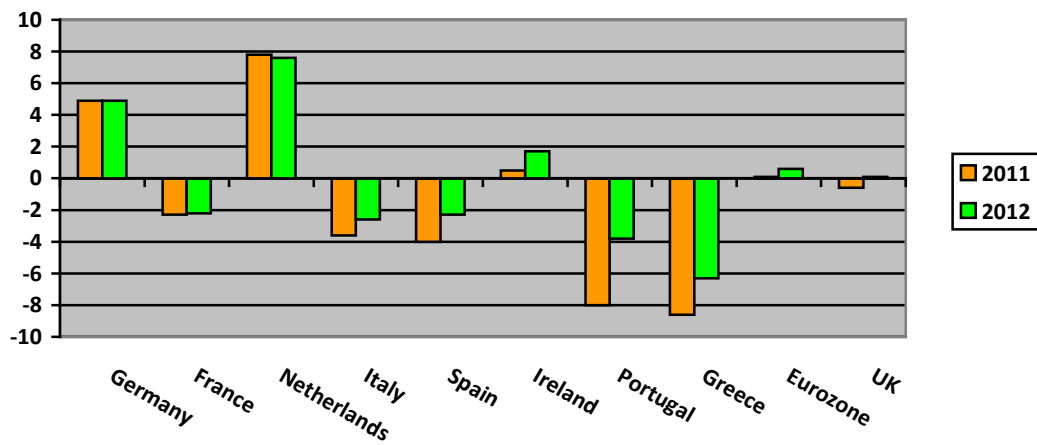


Chart 2b OECD, current account balance, % of GDP: Eurozone countries & UK



Source: OECD, *Economic Outlook, no 90*, preliminary version, statistical annex, November 2011.

Final comment

The OECD attributes at least some of the deterioration in prospects to the Eurozone crisis, as the ECB and the Bank of England. The OECD said "...concerns about sovereign debt sustainability in the European monetary union (...are) becoming increasingly widespread." They also said "...imbalances within the euro area, which reflect deep-seated fiscal, financial and structural problems, have not been adequately resolved. Above all, confidence has dropped sharply as scepticism has grown that euro area policy makers can deal effectively with the key challenges they face."²³

The OECD's assessment is damning and not out of line with many other commentators and policy makers. Christine Lagarde, the IMF's managing director, has also added her voice of concern over the Eurozone, saying that global economic leaders need to take a rounded approach towards addressing monetary weaknesses, such as those underscored by the current Eurozone debt crisis. She said "...it is going to

require efforts, it is going to require adjustment, and clearly it is going to have to start from the core of the crisis at the moment, which is obviously the European countries and in particular the countries of the Eurozone."^{24,25}

Ever since the Eurozone crisis blew up in spring 2010 the EU's leaders have responded with sticking plaster, choosing to ignore the inherent structural flaws. And, as we discuss above, there is no reason to believe the Eurozone countries are now any nearer to resolving the rolling series of debt crises than they were before the recent Summit. Europe's leaders must face up to the inevitable and plan for the orderly break-up of the Eurozone.

Indeed this may well already be happening in the depths of the German Ministry of Finance (for example). We already know that the British Treasury and the Bank of England are planning for all eventualities if the Eurozone breaks up.²⁶ And so are the Eurozone's central bankers.²⁷

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References

1. Stephanie Flanders, "A good deal for the UK - or the euro?", *BBC website*, 9 December 2011, listed Cameron's safeguards as the BBC understood them. (i) A solid principle of non-discrimination. So, for example, the ECB could not demand that all financial clearing houses that deal in euros be located in a Eurozone economy. The UK is currently taking the ECB to court on this point. (ii) The area of "maximum harmonisation" to become subject to unanimity. Under this any EU country would have a veto on any decision to set a ceiling or maximum on a given part of financial regulation. This would mean, for example, that in implementing the Vickers report on banks, the UK could not be prevented from requiring UK banks to hold more capital - or liquidity - than required under EU regulations. (iii) All transfers of supervisory or regulatory powers to EU institutions should be made subject to unanimity.
2. Of the EU's 10 "outs" only the UK and Denmark have formal opt-outs from joining the euro. The Danish crown, however, tracks the euro. The other eight are obliged to join the euro when they meet the Maastricht criteria by the terms of their accession treaties. Sweden however chooses to stay outside the euro.
3. *European Voice*, "Van Rompuy sends EU leaders draft of fiscal union pact", 16 December 2011.
4. *FT*, "Cracks emerge in EU treaty agreement", 14 December 2011.
5. Open Europe, "Continental shift: safeguarding the UK's financial trade in a changing Europe", December 2011.
6. European Council, "Statement by the Euro area Heads of State or Government", 9 December 2011.
7. *FT*, "Eurozone on course to 'fiscal union'", 15 December 2012.
8. *FT*, "Hopes fade for boost to IMF's firepower", 14 December 2012.
9. *FT*, "Cameron rules out putting extra €30bn into IMF", 15 December 2012.
10. Bank of England, "Coordinated central bank action to address pressures in global money markets", 1 December 2011. The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank announced coordinated actions to enhance their capacity to provide liquidity support to the global financial system. The purpose of these actions was to ease strains in financial markets and thereby mitigate the effects of such strains on the supply of credit to households and businesses.
11. *City AM*, "Le crunch", 14 December 2011.
12. ECB, "Introductory statement to the press conference (with Q&A)" for President Draghi, 8 December 2012.
13. *FT*, "Doubts about ECB move to boost bond sales", 16 December 2011.
14. *FT*, "Europe fails to reach summit", 12 December 2011.
15. Martin Wolf, "A disastrous failure at the summit", *FT*, 14 December 2011.
16. Ruth Lea, "Options for the Eurozone: fiscal union or reconfiguration", Arbuthnot Banking Group, 1 August 2011.
17. In early September 2011 the German Constitutional Court ruled that, in order to conform to the constitution, the Bundestag budget committee would have to give prior approval to any future bailout packages or use of the EFSF. This was a major change from the previous situation where the German government only needed to reach a non-binding agreement with the budget committee over any bailouts. Additionally the ruling, *de facto*, imposed further restrictions on Eurobonds or debt mutualisation in the Eurozone.
18. *Daily Telegraph*, "S&P threatens Eurozone credit rating cuts: statement in full", 5 December 2011. Fitch's warned about downgrading Italy, Spain, Ireland, Slovenia, Cyprus and Belgium on 16 December and put France on "negative outlook".

19. ECB, "Introductory statement to the press conference (with Q&A)" for President Draghi, 8 December 2012.
20. Bank of England, "Prospects for monetary policy: learning the lessons from 2011", Spencer Dale, 13 December 2011.
21. OECD, *Economic Outlook, no 90*, preliminary version, press conference, 28 November 2011.
22. Ruth Lea, "Britain will struggle to avoid a "double dip" recession, as Eurozone growth prospects sour", Arbuthnot Banking Group, 7 November 2011.
23. OECD, *Economic Outlook, no 90*, preliminary version, press conference, 28 November 2011.
24. BBC, "Lagarde: No country's economy immune from rising risks", 15 December 2011.
25. *FT*, "IMF chief warns over 1930s-style threats", 16 December 2011.
26. *Guardian*, "UK Treasury prepares for 'economic Armageddon' if euro falls apart", 10 November 2011, reported that the Bank of England was helping draw up British contingency plans.
27. *Reuters*, "Eurozone central bankers crisis planning on the quiet", 7 December 2011.