

Cutting four Gordian knots

A preliminary assessment of the first round of summits

Summary

EU leaders are expected to deliver a 'final solution' to manage and eventually overcome the euro crisis. This analysis of the first round of summits by Janis A. Emmanouilidis shows that much work still lies ahead and warns that EU leaders might not be able to deliver (all) the expected results. The final outcome of the current summit marathon will have to be evaluated on the basis of whether EU leaders have added essential ingredients to an already very complex crisis recipe and whether they have been able to sketch a more ambitious and persuasive roadmap that boosts confidence and provides orientation in the weeks and months to come.

Full report

EU leaders are currently engaged in a summit marathon that includes meetings of the full European Council and the Euro-17 on 23 and 26 October. Following their postponement of the original date and their decision to hold a second meeting of both the European Council and the Euro-17, EU leaders are now expected to deliver no less than a 'final solution' to manage and eventually overcome the euro crisis.

The deterioration of the situation in Europe's periphery, the growing threat of the sovereign debt crisis affecting the core of the euro zone, tensions in the European banking sector, and the danger of a (global) economic slowdown have increased the pressure on EU governments to take bolder actions. Since the summer, eurozone governments – led by Berlin and Paris – have seemed more eager to work out and implement a more comprehensive plan to move ahead of the crisis curve. EU leaders now have to cut four Gordian knots: recapitalising major European banks; strengthening the firepower of the EFSF (European Financial Stability Facility); more sustainable restructuring of Greek debt ('PSI plus'); and, finally, gradually moving towards an 'economic and fiscal union'.

On 23 October, EU leaders discussed and made progress on a number of points, but final decisions will be made and announced later this week in the framework of the next meeting of the Euro-17 on 26 October, which will be preceded by yet another gathering of all 27 heads of state or government.

Analysis of the current state of affairs (see details below) shows that much work lies ahead. Indeed it is possible that the upcoming Euro Summit may not in the end deliver (all) the expected results. The atmosphere ahead and during the first round of summit meetings was tense. The prime minister of Luxembourg and president of the Eurogroup, Jean-Claude Juncker, had expressed discontent over the fact that Germany and France had imposed an additional round of summits on fellow EU leaders. The intensity and gravity of the moment was also apparent during the meeting of the European Council, when French President Nicolas Sarkozy and UK Prime Minister David Cameron had an intense verbal exchange over the future course of action and the relationship between euro and non-euro countries.

EU governments and institutions still need to reach a number of highly complicated and politically sensitive compromises, including EFSF leveraging and details of the

new 'PSI plus'. Other issues will require even more time and effort, including in particular the details of further deepening of economic and fiscal cooperation (not excluding treaty change). And all these decisions will have to be implemented and stand the test of time.

The experience of the last 22 months has shown on several occasions that it is enormously difficult and in many cases even impossible to evaluate the eventual impact of certain decisions on the euro crisis. In the end, the final outcome of this summit marathon will have to be evaluated on the basis of whether EU leaders have added essential ingredients to an already very complex crisis recipe and whether they have been able to sketch a more ambitious and persuasive roadmap that boosts confidence and provides orientation in the weeks and months to come.

The present analysis cannot be more than a preliminary evaluation as the summit marathon continues. However, it will attempt to portray the current state of affairs and raise a number of key issues regarding all four Gordian knots.

Bank recapitalisation

Just weeks after European leaders had criticised similar suggestions made by IMF President Christine Lagarde, the EU-27 have agreed to recapitalise major European banks, providing a buffer to reduce the risk of sovereign debt restructuring.

Until late September 2011, EU officials and government representatives were publicly insisting that there were no problems in the European banking system, arguing that only nine banks had failed the stress tests performed by the European Banking Authority (EBA) in July 2011.

But in the wake of the crisis engulfing Franco-Belgian bank Dexia and amid increased fears of a renewed credit crunch as a result of the potential spillover of the sovereign debt crisis to the financial sector, systemic banks will be asked to increase their core capital rate (core tier 1) to nine per cent by mid-2012. According to official estimates, overall recapitalisation costs will amount to slightly over €100 billion.

The 'coordinated plan' to recapitalise major European banks is likely to come in three stages. First, European banks will be asked to increase their core capital on the grounds of estimates provided by the EBA. Second, banks that are unable to increase their capital rate will have to seek support from their respective governments. Third, if governments are unable to assist their banks, the EFSF might be asked to provide funding through loans to the respective member states.

The details of the recapitalisation plan have not yet been announced, but a number of key questions can already be posed:

- Will a capital increase of €100 billion suffice? Estimates by the IMF and a number of commercial European and American banks suggest that the combined capital needs of major European banks will be much higher – estimates range from €200 to €300 billion.
- Won't the recapitalisation of banks further deepen the sovereign debt crisis in individual EU countries? There is a strong likelihood that a number of major European banks will not be able to raise sufficient capital on the markets. This will oblige governments to provide (additional) money to support banks, which will in turn place a burden on national budgets. Some analysts and rating agencies have already indicated that the recapitalisation of major French banks could threaten the country's rating. This could in turn damage the current crisis recipe, which relies on the ability of triple-A countries to borrow 'cheap money' on capital markets.

- Will the recapitalisation plan undermine the firepower of the EFSF? Some countries – including Greece, Ireland, Portugal and perhaps others – will require loans from the EFSF in order to support banks, thereby reducing its firepower. However, Klaus Regling, CEO of the EFSF, argues that the Facility will be able to cope with the additional costs, as half of the recapitalisation capital would fall on triple-A countries and funds have already been set aside to assist banks in Greece, Ireland and Portugal.
- Could the recapitalisation plan negatively affect the 'real economy'? Representatives of major European banks have declared that they will not ask for public money. Instead they will attempt to sell assets, which – according to them – will reduce their ability to provide loans to the 'real economy'. For obvious reasons, European banks have employed this argument to put pressure on governments to abandon their recapitalisation plans. However, the potential effects of bank recapitalisation on the real economy should not be disregarded, especially in those countries that are suffering hardest from the crisis already.

Leveraging the EFSF

Despite intense negotiations, eurozone leaders have not yet reached a final agreement on how to increase the EFSF's effective firepower. As they seek to provide a liquidity net for all eurozone countries in danger (perhaps eventually including even Italy and Spain), the most likely solution will include leveraging the EFSF by enabling it to provide funds to guarantee a certain percentage of new state bonds against potential losses in the event of default. Estimates foresee that scaling up the EFSF via a type of insurance scheme guaranteeing around 20-25 per cent of fresh debt issues could boost the Facility's effective capital power to above €1 trillion.

A proposal supported by France in particular to provide the EFSF with a banking licence and therefore the opportunity to tap into the European Central Bank's (ECB) liquidity was dismissed following strong opposition from several member states (including in particular Germany but also Austria, Finland, Luxembourg and the Netherlands), the European Commission, the ECB and the EFSF, who all argue that this leveraging model would constitute a breach of EU law (Article 123 TFEU).

However, the idea of introducing an insurance scheme also raises a number of questions:

- Will guarantees of 20-25 per cent be sufficient to entice investors to buy the sovereign bonds of the countries concerned, given that the Greek example already shows that a much higher 'haircut' is possible in the event of a sovereign default (see below)?
- Will the leverage effect be large enough to persuade markets that the EFSF is able to offer a liquidity net to all eurozone countries in danger? If not, it could be argued that the solution of providing the Facility (or later the ESM) with a banking licence might have been economically wiser as it would certainly have provided the EFSF with indefinite firepower.
- The 'limited' leverage effect of the insurance scheme has already triggered debate about other alternatives and three ideas deserve particular attention. The first option involves the quicker introduction of the permanent European Stability Mechanism (ESM) in 2012 instead of 2013; and there is even speculation about a fusion of the EFSF and the ESM. The second option foresees an additional non-European solution, which is based on an increase of the IMF's firepower worth hundreds of billions to finance credit lines to troubled eurozone countries. The third option is based on the argument that the EFSF's firepower could be increased if the Facility were not limited to issuing triple-A bonds; even if this meant that the EFSF would have to pay higher interest rates.

- Who will decide about the use of funds available for providing loans to guarantee sovereign bonds? Some suggest, that the EFSF itself should be able to decide with some autonomy depending on the situation of the country concerned, the maturity of the respective debt, and particular market conditions at the time of issuance. But it seems questionable whether national parliaments of triple-A countries will permit the EFSF such a high degree of autonomy.
- Won't the insurance model create market distortions between new guaranteed bonds and old bonds? Spain and Italy have argued that the existing debt of issuers receiving guarantees could be disadvantaged and that yields of 'old debt' are thus likely to be pushed higher, which in return could force the ECB to purchase further debt on the secondary market.
- Which countries would be covered by the insurance scheme? It is not yet clear whether guarantees will be limited to countries with higher risks, like Spain and Italy, or whether it would also include the three programme countries, i.e. Greece, Ireland and Portugal.

A new 'PSI plus'

Eurozone leaders are pushing for bigger 'voluntary' private sector involvement (PSI) than the 21 per cent discount decided on 21 July. The decision to aim for a 'PSI plus' came amid increasing doubts over the sustainability of Greek debt.

The latest report from the Troika (the Commission, the IMF and the ECB), issued just before the summit, came to the conclusion that the country's debt sustainability had "effectively deteriorated" and that the impact of the financial package agreed in July had been "more than offset".

The Troika report *inter alia* argues that Greek debt can be brought down to just above 120 per cent of GDP by end-2020 if a 50 per cent discount is applied, and that the additional official financial requirements would in this case amount to €114 billion (€5 billion higher than the 109 billion estimated in July). The Troika has also calculated that Greek debt could be reduced to below 110 per cent by end-2020 and additional official financial requirements to an estimated €109 billion in the event of a 60 per cent discount.

The level of PSI increase has been a major bone of contention between Berlin and Paris: the German government holds that Greece will be unable to pay off the scale of its debt and that a bigger haircut is necessary to prevent a disorderly default with unpredictable effects on European and global markets. In more concrete terms, Berlin favours a PSI going beyond a 50 per cent discount, which German banks are likely to be able to cope with, whereas Paris fears that such a high increase could threaten French banks, which are highly exposed to Greek debt.

Just ahead of the EU summit, Eurogroup finance ministers agreed on the terms of a higher PSI (without publicly revealing the details of the compromise) and representatives of the EU and the Institute of International Finance (IIF) are negotiating a 'new deal'; the results of these negotiations are scheduled to be presented before the Euro-17 summit on 26 October.

Following severe pressure from EU capitals, it can be assumed that financial institutions will agree to go beyond the 21 per cent increase agreed in July, because their losses in the event of an 'involuntary haircut' might be much higher; not to mention the potential consequences of a disorderly Greek default ('Lehman II') for the entire European and international financial system. Unconfirmed rumours indicate that the IIF is ready to agree to a 40 per cent discount, but EU negotiators are pushing for a higher rate.

The precise details of a potential agreement are impossible to predict and it is thus difficult to assess the actual effects of a new 'PSI plus' deal. However, it is doubtful whether the 'new deal' will make Greek debt more sustainable for a number of reasons.

A large portion of Greek debt is already held by official lenders (including the ECB, eurozone partner countries and the IMF) and a private discount – even if it is much higher than the 21 per cent agreed in July – will still leave Greek debt levels at a very high level of well above 100 per cent; and this percentage would increase unless Athens is able to achieve a primary surplus in the very near future. Official lenders may eventually have to write down some of the assistance that they have and will provide to Greece. It is also unclear how many private lenders will participate if the conditions of the new deal are 'less attractive' than the 21 July agreement to which more than 90 per cent had subscribed.

Finally, Greek financial institutions will suffer the biggest losses as they hold the largest portion of the country's sovereign debt. Following a bigger haircut, Greek banks, insurance companies and pension funds will most likely be obliged to ask for state assistance, which will place further strain on the country's deficit.

Finally, it cannot be ruled out that the increased pressure on Greek banks might further undermine confidence in the national banking system. More money might flee the country and the likelihood of a massive bank run could increase. Not only would this threaten the stability of the Greek financial system, with direct effects on the 'real economy' if banks are incapable of providing capital to Greek companies, but it could also undermine trust in the banking sector in other European countries. As a consequence, a new 'PSI plus' deal will have to be cushioned through a programme large enough to secure the stability of the Greek banking sector.

Towards 'economic and fiscal union'

The fourth and final Gordian knot which EU leaders need to cut relates to a further deepening of economic and fiscal integration.

At the EU summit on 23 October, the 27 EU leaders decided to make an initial institutional adjustment. The European Council decided that the heads of state or government of the euro area will designate a "President of the Euro Summit" at the same time as the European Council elects its president and for the same period of office. Pending the next election of the European Council president, Herman Van Rompuy will chair Euro Summit meetings.

This decision implies that the president of the European Council and the president of the Euro Summit need not necessarily be the same person. However, it seems likely that EU leaders will continue to opt for a 'double-hatted president' in order not to weaken the institutional and personal links between the European Council and the Euro Summit and thus between euro and non-euro countries. However, as a consequence, personalities from EU countries who have not (yet) introduced the common currency will most likely not be elected as president of the European Council.

In more general terms, the Summit Conclusions note the intention of the Euro-17 to reflect on a further "strengthening of economic convergence" within the euro area and on "improving fiscal discipline and deepening economic union," including the possibility of "limited Treaty changes". The European Council will readdress the issue in December and President Van Rompuy has been asked to prepare a report in "close cooperation" with the presidents of the Commission and the Eurogroup.

The fact that the summit conclusions refer to "limited" treaty change is a concession to the vast majority of EU countries who (strongly) oppose amending the current Treaties, bearing in mind previous 'ratification nightmares' related to the Constitutional and Lisbon Treaties.

However, the German and Dutch governments seem convinced that fiscal integration will require an amendment of the current EU Treaties, arguing that the Union's current primary law does not offer effective mechanisms to oblige countries to adhere to the rules that underpin the euro.

German Finance Minister Wolfgang Schäuble maintains that a readiness to steer the euro zone towards a fiscal union will send a strong signal to financial markets; and Chancellor Angela Merkel has even indicated that more control over national budgets would eventually lead to a more favourable climate for considering Eurobonds – a strong argument for the majority of EU countries who favour the ‘socialisation’ of European debt.

Many of the issues related to the actual content and procedure of another round of treaty reform remain very vague. In the last couple of weeks an increasing number of government representatives, political parties and individual politicians have been putting forward ideas.

Suggestions include *inter alia* (1) the introduction of a special European commissioner to oversee the budgets of euro-area countries, with the ability to intervene directly in euro countries which have repeatedly breached the rules of the Stability and Growth Pact: placing such countries under a form of “guardianship”; (2) the Commission should be able to refer countries that fail to obey the rules of the SGP to the European Court of Justice; (3) ‘notorious sinners’ could lose their voting rights in the Council; (4) the introduction of a separate ‘euro chamber’ or a ‘euro committee’ within the European Parliament; (5) the creation of a separate, independent institution (not the Commission!) tasked with carrying out fiscal and budgetary supervision; (6) developing the ESM into a ‘European Monetary Fund’ capable of directly interfering with the budgets of countries that ask for financial assistance; (7) EU citizens should elect an ‘EU President’; (8) the introduction of more qualified majority voting in the (European) Council or even in the framework of Euro Summits; or (9) a higher degree of tax cooperation.

Most of these and other proposals have not been spelled out in detail. It is thus difficult to assess whether or to what degree such reforms would necessitate treaty change. Some things could be implemented even if not all member states are ready to support a higher degree of cooperation by applying existing instruments, for example enhanced cooperation in the area of tax coordination.

However, most of the proposals mentioned above would probably require some form of treaty change. The extent to which the EU’s primary law would have to be amended varies significantly, ranging from a very limited treaty amendment decided upon in the framework of a ‘quick’ Intergovernmental Conference to a large-scale legal operation. Some treaty amendments could be achieved by simply applying the existing ‘passerelle clauses’ (e.g. concerning the extension of qualified majority voting in the Council). Other more complex amendments would most likely require a European Convention involving European and national parliamentarians as well as representatives of EU governments and the European Commission. German government representatives have already called for a European Convention to draw up a new treaty on the basis of a very limited mandate and a very strict timetable.

All the above-mentioned treaty changes (with the exception of those based on passerelle clauses) would have to be ratified in all 27 EU countries before they can enter into force; in several member states this would require a referendum and in some cases maybe even an amendment of the national constitution. The problems this could cause should not be underestimated, especially as national parliaments and/or citizens may be asked to agree to a treaty change which could substantially limit their fiscal sovereignty.

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