Encima Global

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Europe Agrees to Do More; Growth Still Unlikely

Europe reached several agreements that are lifting world equity markets and the euro and causing slight reductions in bond yields in Italy, Spain and Portugal. European leaders worked longer on Wednesday night than we expected, agreeing on:

- Greece's second IMF aid package (130 billion euros up from 109 billion agreed to on July 21 and 110 billion in the 2010 package).
- A 50% voluntary private sector haircut (was 21%); the details and participation are to be negotiated by year-end; and
- A framework for spending the remaining EFSF funds (some has already been committed to Ireland and Portugal). The EFSF will contribute to the second Greece package (perhaps 70 billion euros in place of the EC contributions in the first package.) It will be allowed to sell first-loss insurance on newly issued sovereign bonds (for example, the first 20% of new issues of Italian bonds.) Through a fund that may take private sector investments, the EFSF can buy sovereign bonds (as the ECB has been doing) and make loans to help recapitalize banks. China, other emerging markets and Japan have indicated interest in co-investing with the EFSF.

Our View

The set of agreements is **more of a "puffer fish" approach than a 'going all-in' bazooka.**

- **Europe is making the most of limited resources**, hoping the comprehensiveness of the agreements will scare pessimists and restart investment in European bank and sovereign bonds.
- **But the ECB won't be expanding its bond purchases; there are no broad new guarantee authorities for bank liabilities along the lines of the 2008 FDIC guarantees for new U.S. bank debt; and many banks are likely to be forced to apply mark-to-market more aggressively, to reduce their leverage ratios, and/or to increase equity capital.**

There are several important **open issues**:

- **What are China's terms for adding more funding?** China will probably ask the European Union to give it full WTO status. This would remove some key European

trade barriers, allowing China to sell autos into Europe at the expense of heavily subsidized European production like Fiat. China might also ask for a high ROI on its contributions to the insurance fund.

- How much will this approach slow the **ongoing cash drain** from weaker euro-zone countries including: 1) falling tax receipts and rising fiscal deficits; 2) the run-off from maturing sovereign debt; and 3) the shrinkage in bank liabilities in the weaker countries. There's not that much new money in this approach compared to the cash drain under current (weak) economic programs.

- **We're skeptical Greece's deal will work.** Greece's creditors say the deal for a 50% haircut will lower Greece's debt by 100 billion euros. However, the actual cash-flow savings to Greece won't be much. The debt reduction still leaves Greece with an upwardly trending 120% debt to GDP ratio and a big fiscal deficit. Creditors will try to get critical mass by year-end in order to comply with the restructuring deal and keep Greece paying the coupons. Part of the challenge is to avoid triggering CDS contracts by calling the deal voluntary. The legal avenues for challenging this haven't been explored yet. Toward conditionality in the second Greek package, the IMF will be able to count the tax increases and early retirements Greece approved recently. The IMF will be able to find the Greek program 'fully funded' by assuming the recession softens in 2012, tax collections are robust including the new taxes, and the debt restructuring allows Greece to start borrowing again. These will all be tested in early 2012 as Greeks are asked to pay taxes, pay the new property tax, and accept reductions for government workers.

- **Debt contagion is still a big problem.** Greece's bigger haircut has implications for Portugal and raises questions about the ultimate repayment of Italians and Spanish debt. We think the mechanism for this contagion is through growth and investment – which will be delayed in the weaker countries until there's a clearer resolution of the debt overhang.

- **We expect European banks to shrink their assets** through asset sales and by not rolling over maturing assets. This creates problems for existing borrowers – trade finance, medium sized businesses in Europe and in emerging markets. In the long run, this is probably a good evolution in Europe's overgrown banks, but in the short run it will cause strains because new lenders may not view borrowers as favorably as current lenders have.

- **Bottom line: This is still a kick-the-can framework to push the immediate problems into 2012. It doesn't stop Europe's slowdown. To make it work, Italy and Spain have to step forward with transformational structural reforms, unlikely in the current political mix. On the positive side, it demonstrated the euro zone's ability to make decisions and take losses; and it sets up a new institutional structure that is powerful but doesn't violate Germany's aversion to a fiscal union.**

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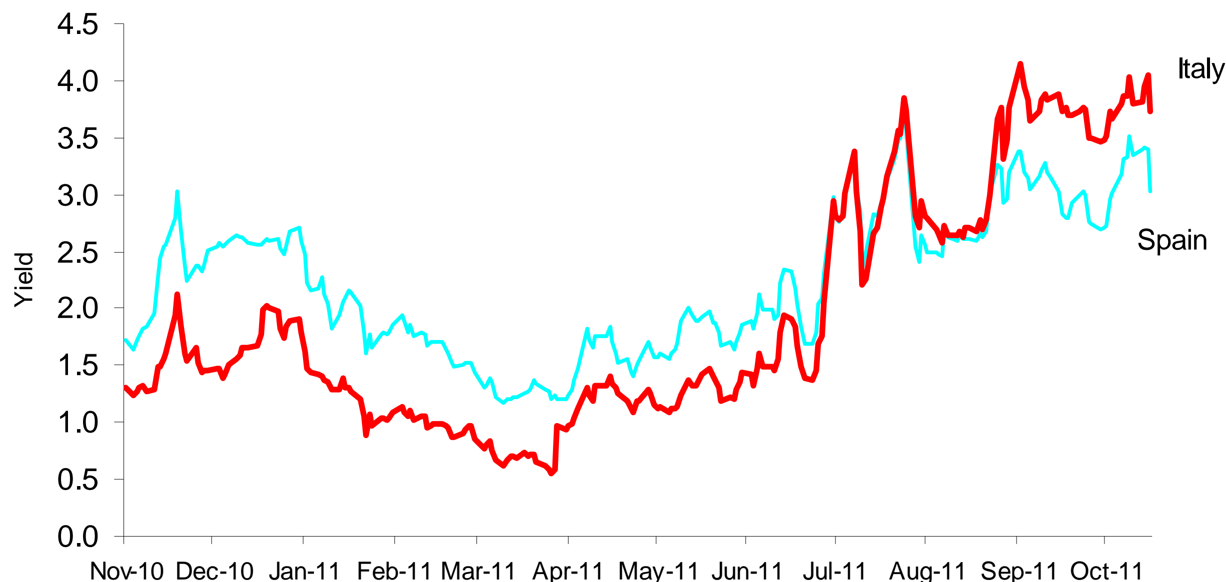
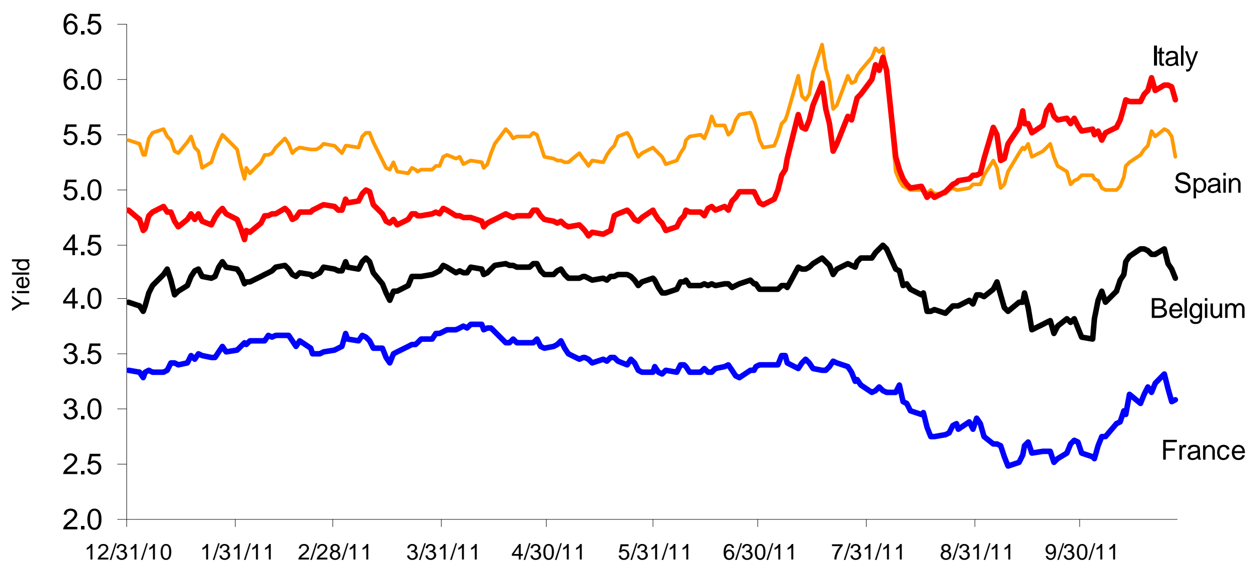
Italy and Spain 2-Year Yield Spreads (last obs. October 27, 2011)



Source: Bloomberg; Encima Global

Selected European 10 Year Yields (last obs. October 27, 2011)



Source: Bloomberg; Encima Global

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