

## The complex end of a summit marathon

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The compromise reached by EU leaders on the three key issues discussed by the European Council and the Euro Summit on 26/27 October – i.e. the restructuring of Greek debt, leveraging the EFSF (European Financial Stability Facility) and bank recapitalisation – is very complex and difficult to evaluate. It lacks a number of crucial details which still need to be elaborated, it leaves numerous questions unanswered, and it is by no means clear whether the overall package will stand the test of time.

The final result of an unprecedented summit marathon, which featured two European Council and two Euro Summit meetings within four days, has added a number of essential ingredients to an already very compound crisis recipe. But it is by no means clear whether the final package will be able to boost confidence and provide orientation in the weeks and months to come. Nonetheless, EU institutions and eurozone governments – led by Berlin and Paris – now seem more determined to get ahead of the crisis curve. However, despite the progress achieved, analysis of the compromise's three major elements indicates that the EU has not yet been able to sketch out a comprehensive, ambitious and persuasive final roadmap that includes all the details required to manage and eventually overcome the crisis.

With respect to the restructuring of Greek debt, after tough late-night negotiations EU leaders reached an agreement in principle with private investors regarding a 'voluntary' 50 per cent haircut in the nominal value of Greek bonds, a compromise substantially higher than the previous agreement of 21 July. However, representatives of the EU and the Institute of International Finance (IIF) still need to settle the concrete terms of the private sector's involvement (PSI), which is supposed to reduce Greek debt held by private bond holders by roughly €100 billion. At this state it is impossible to assess how many private lenders will subscribe to the new deal if its conditions are 'less attractive' than the previous agreement.

Overall, the new PSI deal aims to secure a decline of Greece's overall debt ratio to 120 per cent by 2020. But will 'PSI plus' (or 'PSI 2') really make the level of Greek debt sustainable if it leaves it well above 100 per cent? Reaching a truly sustainable debt level will depend very much on whether Greece quickly achieves a primary surplus and whether it finally embarks down the road to economic recovery. Eurozone members and the International Monetary Fund (IMF) seem ready to provide additional programme financing of up to €100 billion until 2014. However, at some point in time public lenders (including partner countries and the European Central Bank; ECB) might also have to be prepared to write down some of the rescue assistance provided to Greece.

In a bid to prevent the debt crisis from potentially spilling over into the financial sector, the EU 27 have agreed to recapitalise major European banks, which will be asked to increase their core capital rates (core tier one) to nine per cent by mid-2012. Recapitalisation will require banks to seek capital increases worth a combined total of €108 billion, according to EU estimates. But is this number realistic? Won't capital needs be substantially higher, as IMF numbers and other calculations seem to indicate? In addition, there is a danger that recapitalisation could squeeze a number of eurozone countries further into a corner, if they have to provide (additional) money to support their banks. And finally, the recapitalisation plan could have a negative impact on the 'real economy', if banks are forced to reduce their lending capacities.

Finally, EU leaders have agreed on two basic options for leveraging the EFSF's resources. The first option foresees the provision of credit enhancement to new debt issued by euro countries, a kind of insurance scheme guaranteeing a certain percentage (probably around 20-25 per cent) of fresh

debt issues by countries in danger. The second option includes the establishment of one or more special-purpose vehicles able to attract additional liquidity from private and public financial institutions and investors. In addition, the euro zone will consider how to further enhance the EFSF by cooperating more closely with the IMF, thereby finding new means to attract non-European capital in particular.

With respect to the new insurance mechanism, it is by no means clear whether 20-25 per cent will be sufficient to entice investors to buy bonds, given that the Greek example shows that a much higher 'haircut' is possible in the event of a selective default. Regarding the second option and the idea of enhancing the IMF's involvement, it remains to be seen whether private and public investors will be encouraged to invest or lend more money. In general terms, it is also not clear whether the leverage effect will be large enough to persuade markets that the EFSF is able to offer a large enough liquidity net to all eurozone countries in danger. As a consequence, the idea of providing the EFSF (or later the ESM; European Stability Mechanism) with a banking licence – promoted by France – might at some point return to the table, as it could certainly provide the EFSF/ESM with indefinite firepower.

An initial analysis of the Euro Summit reveals many uncertainties related to the compromise and it is by no means certain that restructuring Greek debt, strengthening the EFSF and recapitalising banks will deliver the expected results.

However, at the same time, there are a number of more fundamental positive developments that must not be ignored. Everyone seems to have finally acknowledged the gravity of the crisis, which not only endangers the stability of the common currency but also casts doubt on the fundamentals of European integration. Compared to a year ago, in Europe and beyond there is now a strong appreciation of the fact that the euro is 'too big to fail'. This is good news, as it amplifies the pressure on EU governments and institutions to take bolder action and thus increases the likelihood that the sovereign debt crisis will eventually be overcome.

However, looking beyond the immediate effects, there is a need for increased awareness of the potential collateral damage that this crisis may still inflict: its unintended and unexpected economic, political and/or social consequences at both national and European level, which are not always immediately apparent but could ultimately jeopardise the Union's overall ability to address current and future challenges. We are already witnessing dangerous tasters: the rise of Eurosceptic populism, parochialism and nationalism, the first messengers of a profound crisis of democracy, and growing distrust and division between national capitals: all these are developments fostered by the crisis which will probably haunt the EU for a long time.

In the more immediate future, one political risk could fundamentally jeopardise the entire eurozone rescue: the danger of a structural split between Berlin and Paris. The crisis has disrupted the old balance of equals, as Germany is in a much stronger position while the *grande nation* is fearful of losing its triple-A rating. Until now, both sides have been very much aware that resolving the crisis requires them to seek and find compromises – even though this has not always been easy and even though it has been often criticised by other EU members.

However, the relationship could be seriously put to the test should the balance shift even more in the direction of Germany and should the going get rough(er) for France. If that moment in time comes, Berlin will have to show its full and steadfast support and may be forced to shoulder an even greater share of the crisis burden.

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