Eurozone finally agrees a deal but uncertainties remain unresolved

After protracted negotiations, Eurozone leaders finally agreed on a new package of measures last week. The outline deal has a three-pronged approach aimed at tackling the main aspects of the crisis: reducing Greece's debt burden, avoiding a credit crunch by recapitalising European banks, and preventing contagion to other countries via a boost to the EFSF.

But while the initial market reaction was positive, with a substantial relief rally, this rally is already fading. One problem is that the terms of the deal are vague - Eurozone leaders have only been able to agree on a bare minimum of measures ands words. There are uncertainties about the details of the proposed Greek debt swap, and significant concerns about the plans for the EFSF. And the deal continues to rely on rather optimistic assumptions, such as plans that Greece will raise an extra €15 billion in privatisation on top of the already very ambitious €50 billion set out in the previous deal

On top of these uncertainties, the Greek government has now added a new factor in the shape of a proposed referendum on the new deal, the outcome of which is quite unpredictable. This threatens to maintain uncertainty and volatility at high levels to the end of the year and could even trigger a disorderly default by Greece in the event of a 'no' vote. Such an outcome would risk considerable costs in terms of economic growth and financial contagion.

Outline rescue plan agreed…

After weeks of discussions and political negotiations, the heads of state of the Eurozone reached an outline agreement to bring to an end the financial crisis in the region on the evening of October 26th. The three-pronged plan deals with the key elements of the crisis: reducing Greece's debt burden, avoiding a credit crunch and preventing contagion to other countries.

The first part of the plan, the Greek debt restructuring, aims to reduce Greek government debt from 160% of GDP to 120% of GDP by 2020. The Eurozone leaders' communiqué indicates that to achieve this goal, private bond holders of Greek debt will assume a voluntary 50% haircut via a new debt swap. Up to €30 billion will be contributed by the Eurozone members to this proposed debt swap in the form of 'sweeteners' and the exchange of bonds is planned to take place in January 2012.

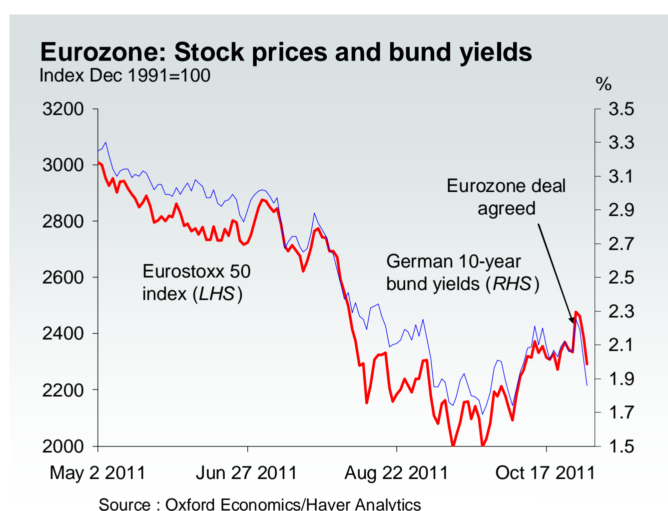
The second part of the package aims at avoiding an outright contraction of credit in the region by capitalising European banks. Banks will need to raise €106 billion of extra capital by June 2012. Most of the effort will be undertaken by Greek, Spanish and Italian banks, which will have to raise €30, €26 and €15 billion respectively.

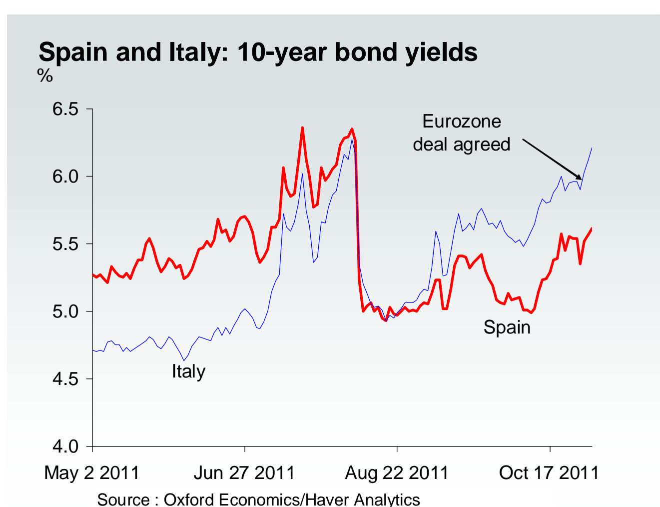
In the case of France and Germany, the requirements are less demanding; four French banks will together have to raise capital by €8 billion, while thirteen German banks will raise €5.2 billion. Banks will be required to increase their tier one capital ratio to 9% by June 2012, with this target being in line with Basel III standards. Institutions struggling to meet these requirements will be prevented from distributing dividends and paying bonuses.

The third element of the package seeks to prevent contagion to other Eurozone members through a strategy that aims at enhancing the fire-power of the European Financial Stability Facility (EFSF). The former will be achieved through raising funds from private and public institutions and investors using a Special Purpose Vehicle (SPV) and offering investors the option of purchasing risk insurance for new debt issued by member states in the primary market. It is envisaged that this insurance would cover the first 20% of any losses suffered by investors on new debt issued, and that the proposals would allow the effective capacity of the EFSF to be 'leveraged up' to around €1 trillion.

...but market relief proves brief...

The initial response of the market to the deal was positive, with a substantial relief rally that saw Eurozone stock prices rise as much as 6% and German bund yields rise steeply. But the renewed risk appetite of investors quickly began to fade, and much of the initial market reaction has already been reversed. The Eurostoxx 50 index has dropped below pre-deal levels and German 10-year bund yields are below 1.9%. And bond yields in Spain and Italy rebounded quickly after an initial dip – to over 6% in the case of Italy - especially worrying given that one of the main aims of the deal was to prevent contagion to these two large economies, given the systemic financial risks that could pose.





The subsidence of initial market optimism in part reflects the fact that the deal has left a number of important questions unanswered. The agreement suggests Greece's debt/GDP ratio will be reduced to 120%, with the larger 50% haircut for private sector bondholders playing a key role. But the precise details of the debt swap are lacking. Some spokesmen for bondholders are suggesting the deal may be more generous to them than the headline 50% figure implies, and the deal also relies on a very high level of participation to succeed. But it was already proving a struggle to get enough bondholders to sign up to the smaller 21% haircut agreed in July and the new deal does not feature any mechanism for enforcing participation – indeed, the Eurozone authorities are going out of their way to avoid any kind of coercion of bondholders to try to maintain that the haircut is 'voluntary'.

Worryingly the deal also still relies on Greece achieving very high revenues from privatisations. Indeed, the deal talks of Greece raising an additional €15 billion from this source. This comes on top of the €50 billion target set out in the previous negotiations – a target that was incredibly ambitious considering that Greece's GDP is expected to contract over 6% this year and that the current price of state-owned assets is likely to be depressed.

It is also unclear whether a debt/GDP ratio of 120% of GDP is sustainable for Greece. This remains a very high level, implying a heavy burden of interest payments and leaving Greece's debt dynamics vulnerable to additional shocks and to weak economic growth. As a result, with a large part of Greece's debt now owed to official lenders (i.e. the EU and IMF) some investors are questioning whether or not an even bigger haircut for private bondholders might ultimately be required.

Regarding the capitalisation of European banks, there are question marks about how some banks, especially Portuguese, Italian and Spanish banks, will be able to comply with the new capital requirements given current market conditions. One risk is that, rather than improving capital ratios by raising new capital, banks might do so by reducing their balance sheets instead – implying a cutback in lending exacerbating the economic downturn. How this will be prevented is as yet unclear.

These concerns are exacerbated by the lack of details on the EFSF. Basically, it is unclear what share of the EFSF will be allocated to risk insurance and what share of the facility will be available to provide support for bank recapitalisation and for buying bonds in the primary and secondary market. There are also questions about whether the risk insurance plan for the EFSF will work. Firstly, as the proposed insurance will apply only to the flow of new debt, not the stock, the plan actually risks fragmenting the bond markets of the countries involved with older debt perhaps trading at a discount to the new debt. This may be one factor behind the rise in Spanish and Italian yields since the deal was announced.

It is also unclear whether the supposed firepower of the new EFSF of €1 trillion is really sufficient to tackle crises in Spain and Italy should they occur – pre-deal estimates suggests firepower of two or three times this size might be needed to completely reassure markets. This leaves both Spain and Italy needing to move rapidly to enact domestic measures that will reduce the perceived risks to their long-term debt sustainability. But in Italy, political barriers to the kind of rapid action needed remain significant and both Italy and Spain are also suffering from stagnant economic growth – Spanish Q3 GDP released this week came in at zero.

Meanwhile, investors also seem reluctant to subscribe to the EFSF, perhaps unsurprisingly given the above uncertainties. At the latest sale of EFSF bonds, weak demand led to a 40% cutback in the amount offered and much wider spreads over German bunds than earlier this year.

…and Greek referendum announcement adds to the uncertainty

Rather than coming up with a 'big bang' announcement that would impress markets and draw a line under the crisis, the Eurozone leaders appear to have instead agreed only a bare minimum of measures and words. But producing a vague outline with details to be filled in later is a dangerous approach given the seriousness of the financial situation and the increasing evidence of a negative impact on the real economy in the Eurozone.

On top of this, the Greek government has now added a new factor in the shape of a proposed referendum on the new deal. The outcome of this is quite unpredictable – while the Greek authorities apparently plan to offer Greeks a choice between 'Europe' and economic and financial regression, the government is unpopular as a result of the harsh measures already implemented and there may also be concerns among Greek voters at some of the proposed details of the new deal including the 'on the ground monitoring team' which potentially infringe Greece's sovereignty. Moreover, the proposed referendum may not take place until January, threatening markets with a period of high uncertainty and volatility over the year-end period.

Should the Greek people reject the new deal, this could trigger a disorderly default by Greece, featuring a probable wipe-out of private sector bondholders and perhaps significant losses also for some official lenders – for instance the ECB via its holdings of Greek government debt. Such an outcome would also likely trigger a serious wave of financial contagion to the other 'peripheral' Eurozone states, threatening a series of further defaults.

This would risk generating significant output costs for the Eurozone and the wider world. Our model estimates of a 'peripheral crisis' scenario featuring a disorderly default in Greece, further defaults in Ireland and Portugal and severe bond market stress in Spain and Italy suggests the Eurozone as a whole would be plunged back into recession, with GDP shrinking by 1.0% in 2012 and stagnating in 2013. If the authorities were unable to prevent Spain and Italy also being dragged into default, the consequences would be far worse, with a 'global crisis' featuring a recession in the US and other major economies and an abrupt slowdown in global growth to just 1.5% (at PPP exchange rates by 2013) with even the fast-growing BRIC economies decelerating sharply.