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Focus notes: Greece

December 16-17 EU Council announcements and assessment

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According to a statement released y-day by EU Council President, Van Rompuy, the following important issues have been decided during the first session of the Dec. 16-17 meeting of the EU27 heads of states:

- The EU Council confirmed the general futures of a permanent crisis resolution mechanism, i.e., the so-called European Stability Mechanism (or ESM), that will become operational right after the present EFSF/EFSM facility expires in June 2013. Note that the creation of such a mechanism has been debated since late October, when the European Council agreed on the need for 'limited' amendments to the Lisbon treaty. A general outline of the modalities and operational characteristics of the ESM was presented in a Eurogroup statement on November 28 .

- The Council decided on limited changes to the Treaty that will enable member states to establish the proposed permanent crisis resolution mechanism. Specifically, according to a draft decision agreed by the heads of states, the following two sentences will be added to article 136 of the Treaty:

    i. "The Member States whose currency is the euro may establish a stability mechanism to be activated if indispensable to safeguard the stability of the euro area as a whole"

    ii. "The granting of any required financial assistance under the mechanism will be made subject to strict conditionality."

- The agreed Treaty amendments will be made using a simplified revision procedure of Article 48.6, since they will not increase the competence of the European Union and only affect the members of the euro area themselves. Regarding the relevant timetable ahead, the Council's draft decision on these amendments will become a final decision by March 2011 at the latest, following a formal opinion by the European Parliament, the European Commission and the European Central Bank. Then, the amendments will need to be approved in each member state, with a view to have them enter into force by January 1, 2013 and become fully operational by June 2013.

- The proposed European Stabilization Mechanism will be designed on the basis of the present EFSF/EFSM facility, which foresees involvement of the IMF. Regarding the involvement of private sector creditors in any future sovereign bailouts, the EU Council confirmed y-day that such an involvement would not be a prerequisite for the provision of support under the new mechanism. On the latter issue note that, in line with the Nov. 28 Eurogroup statement, the private sector would share some of the rescue costs in the event of a sovereign default, but only on "a case-by-case basis" and in accordance with current IMF policies. Thus, private bond holders will not automatically take a "haircut". The involvement of the private sector would be gradual, with haircuts been only used as a last resort solution. Furthermore, private sector creditors will be encouraged "to maintain exposure" in a EU country facing liquidity problems, provided that the sovereign borrower in question is deemed solvent on the basis of a debt sustainability analysis conducted by the EC, ECB and the IMF.

In additional to the above, the EU Council decided y-day to:

- Conduct new stress tests in the banking sector to ensure full transparency in the broader context of the EU annual exercise.
- Request the other EU institutions to make sure that all the decisions adopted in October regarding the Stability Pact and macro-economic surveillance will be in place by summer 2011.

Finally, the Council expressed full support of the action of the ECB and reiterated that the heads of state and government of the Eurozone stand ready to do whatever is required to ensure the stability of the euro area.

Brief assessment

Y-day's public announcements by the EU Council were broadly in line with market expectations, containing little in terms of new information regarding the specific modalities and technical aspects of the future European Stability Mechanism (ESM). Furthermore, no new information was provided regarding a number of other important issues as the proposed issuance of E-bonds and the potential increase of the size of the present EFSF facility.

On the latter, Mr. Rompuy reiterated earlier today that EU leaders are ready to do whatever is needed to ensure stability in the euro area and said that "there is sufficient leeway" with respect to the present €750bn rescue facility if needed. Regarding the idea of issuing joint Euro zone bonds – dubbed E-bonds –, German Chancellor, Angela Merkel, was quoted in a newspaper interview on Thursday as saying that she had settled a dispute between her and Luxembourg's Prime Minister Jean-Claude Juncker over the issue. Mr. Merkel explained why she was against the issuance of such joint bonds and, instead, appealed for closer cooperation on economic and financial policies in EU. In a separate interview ahead of the Council meeting, Mr. Juncker said that he intended to raise the said topic, although he did not expect a decision.

Two other important issued that need to be clarified with respect to the future permanent crisis resolution mechanism relate to its potential size and the application of the so-called collective action clauses (CACs) for debt restructurings. It seems that we need to wait till March 2011 to learn more about these issues, but as Ms. Merkel reiterated earlier today, existing holders of Eurozone government debt would not be affected by a decision to involve private investors in a future permanent rescue mechanism.

In all, given the present lack of detail with respect to operational characteristics of the new mechanism, and in view of prevailing market sentiment towards EMU, we may well see pressure on the euro and euro area assets resurfacing again. It appears that other euro area countries including Portugal, Belgium and Spain have already come in the spotlight and markets will probably try to pursue the EMU breakup theme once again in the non distant future.

In a more reassuring note, recent policy initiatives by Euro zone authorities suggest that significant progress has already been made towards strengthening budgetary discipline and creating a coherent medium-term framework for dealing with future crises in the common currency area. Furthermore, EU Council's confirmation that private sector participation in sovereign bailouts would only be considered as a last-resort measure should also help to soothe investor fears over a further significant short-term widening in EMU periphery spreads.

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