The debt crisis

EU summit: Business as usual?

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- The upcoming European Union summit of 8-9 December 2011 raises a range of expectations related to strengthening Eurozone fiscal sustainability.
- We do not expect strides toward a fiscal union; we foresee instead agreement on provisions to make stability measures more credible and tangible.
- The European Central Bank (ECB) will remain the lender of last resort for solvent banks, at least in the market expectation, while Draghi attempts to send restrictive signals to governments.

A regular summit of European political leaders will take place on Thursday and Friday, 8-9 December. Such meetings are usually scheduled twice per term to present medium- and long-term guidelines, and to decide on political measures largely related to current issues. Any agreement requiring an amendment of the EU Treaties, such as a transferral of competences, needs the approval of all 27 member state parliaments. Depending on national law, some countries must hold referenda. The same applies for treaties concluded between member countries when the content provides for a repartition of tasks.

Source: Dreamstime

Please also refer to our previous reports in the series "The debt crisis" as well as the Research Focus "Sovereign default in the Eurozone - Greece and beyond."

Uncertainty about what is desirable

With the euro crisis continuously eroding market sentiment and forcing downward revision of economic forecasts, the hope for political salvation mounts. The following scenario often characterizes an approaching – and also this – summit: In a first phase, pressure on politicians rises, opaque pre-meetings occur between select leaders, and a determined will to act is demonstrated. Markets observe, attempt to interpret, and let the risk – of inaction or an untoward outcome – premium rise. Then the summit concludes with a strong commitment to strengthen the economic and monetary union, a road-map with possible measures to be implemented during a transitional phase and a celebrated solidarity acknowledging the historical responsibility. As a consequence, markets used to react with relief – at least for a couple of days. Afterwards, when measures are revealed as inadequate to solve the core problems, ad hoc actions are necessary to maintain a relative stability within the Eurozone. This is when the ECB takes the stage in a major role and the markets level out at the pre-summit level of uncertainty.

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The EU summit: strengthening the exisiting framework?

Possible outcome

The question arises whether there are reasons to believe that this time will be different. With regard to the ongoing euro crisis, speculation is rampant about possible measures to be decided by the end of the week. Markets expect at least a "sustainable" concept for fiscal policy. The challenge here is that the short-term market view hopes for another rally, differing from the long-term economic perspective which expects a fundamental correction. A default by Greece, for instance, is very likely to trigger immediate economic distress, while in the long term, the Eurozone economy may be unburdened and investor confidence strengthened. Among the wide range of items – concepts, solutions, proposals – being discussed, we classify the possible summit outcomes into three basic categories named after their essential characteristic:

- "Rubicon:" European leaders could undertake a clear step toward a fiscal union. While a notion of continuous progress adheres to this undertaking, we see a distinct threshold, which we refer to as the Rubicon (the northeastern Italian river marking the point of no return when Caesar crossed it with his army in 49BC). The first step is made from the moment when fiscal responsibility is transferred on a supranational level, such that for member states temporally unlimited financial obligations emerge for a considerable share of their governmental budget. This coincides with the ruling of the German Constitutional Court on 7 September 2011, and would apply already with the issuance of Eurobonds or stability bonds, as well as in the case of the blue and red bond concept (common pool for the first 60% of debt (=blue bonds), national issuance for the rest (=red bonds)), and ideas for automated transfer mechanism.
- "Effectiveness:" Efforts could focus on making the current institutional framework more reliable and consistent. In principle this means embedding the spirit of Maastricht (Maastricht 2.0) in a better system of rules and incentives (checks and balances), making it less an object of political misuse. This would entail the anchoring of debt brakes on a national constitutional level, so that politicians of member states are forced to commit to more sustainable fiscal policy. On the European level, the enforceability of fiscal obligations could be leveraged by involving the judicial power, i.e., making governments more responsible for their fiscal policy (e.g., by giving the European Court the competence to assess the introduction of fiscal rules into national law). Within the so-called "Six pack" – a package of six proposals to foster economic and fiscal co-ordination – provisions are already being deployed to submit national budget processes to a European monitor. Based on these proposals, additional stronger rules could be enacted with tangible decision-making power for the EU Commission, including the competence to act autonomously in the case of infringement of a stability policy. That model would follow the existing one for competition policy. Finally, different ideas on how to penalize member states are being discussed, be it as consequence of an assessment by the Commission or of an automatic trigger like passing a debt limit (recently proposed to be set at 3% of GDP). However, financial penalties are not effective for countries already accumulating too much debt, and even stricter budget rules will need to balance the desire for fiscal stability and economic growth if an economy goes into recession. It is worth keeping in mind that Italy, Spain and Ireland were not in breach of the stability criteria, nor of a German-style debt brake, until they were hit by the crisis in 2009.
- "Zero-decision:" Another possible outcome of the summit could be, that no agreement is reached to change the status quo. This would not be declared as such, but communicated by saying that there is a need to elaborate more on the topic with the necessary diligence. Nevertheless, in the case of an upcoming liquidity stress situation, the ECB might step into the breach again as a lender of last resort. The next ordinary opportunity for heads of state to tackle new needs for

Fig. 1: Possible strategies at the EU summit

Strategy	*Characteristics*
"Rubicon"	• Transfer of fiscal policy • Temporally unlimited obligation • EU Treaty change necessary (approval by all member states) • Eurobonds
"Effectiveness"	• Based on existing framework • Strengthening the sanctions mechanism • EU Treaty change or simplified procedure within the Council • Debt brakes on national level
"Zero-decision"	• No measures decided • ECB plays a major role

Source: UBS WMR

revision is scheduled for 1-2 March 2012, except if a more frequent meeting schedule, e.g. monthly, is decided at the summit.

Base case

We think any sub-variant of the "Rubicon"-strategy is not to be expected for this summit and the near future, as this would entail a protracted approval process through all member states, with uncertain outcome due to limited acceptance by net-contributor countries. Given the high expectations put on the summit, the "zero-decision"option does not seem very likely, either. The summit offers the opportunity for Nicolas Sarkozy to strengthen his domestic political position, for which reason he may be highly willing to deliver results.

Our base case for the summit is a combination of "effectiveness"measures (Maastricht 2.0) similar to those discussed on the occasion of the bilateral meeting between Angela Merkel and Nicolas Sarkozy on Monday, 5 December. What could probably be excluded is – within the EU-27 – a tangible strengthening of the Commission to avoid a shift of competence away from the Council, as well as from the Eurozone-17 framework to the EU-27.

ECB policy driven by government actions

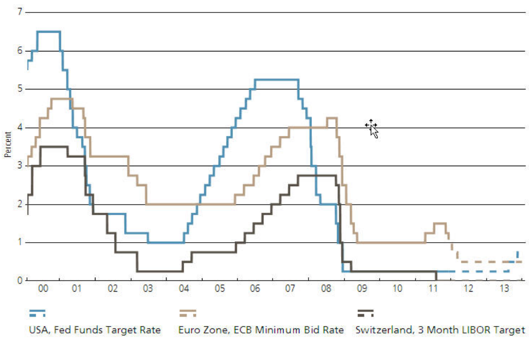
Mario Draghi expressed to the European parliament last week that he believes that most European nations are overall on the right track, but that a "fiscal compact" enshrining the ad hoc fiscal commitments and rules seen so far is required to restore confidence. Indeed, we believe that the ECB would act more decisively if governments would follow his "advice" of a fiscal compact, which is our base case. We would thus expect the ECB to play ball going forward, as Angela Merkel and Nicolas Sarkozy are likely to have exchanged views with the ECB and are probably taking its expectations into account.

What can the ECB do? While Mario Draghi said explicitly that the ECB is the lender of last resort for solvent banks, he also signaled that the ECB is not the lender of last resort for sovereigns – at least not directly – and he indirectly pointed at governments' duty to deal with insolvent banks. Restoring the health of the banking sector, though, would support the sovereign market indirectly under certain conditions. In the last couple of months, we have seen this dynamic working in the opposite direction, in fact financial institutions sold government bonds amounting to almost EUR 59 billion from July to October, according to the ECB. In order to reverse this dynamic or stabilize it, we would expect the following measures from the ECB:

- Reduction of refinancing rate by 25 basis points
- Offering to banks of Long Term Refinancing Operations by at least two or even three years, with full allotment to ease the asset liability mismatch on bank balance sheets
- Widening of eligible collateral pool and/or lowering of collateral requirements

For a maximum impact of these measures, banks need an incentive to buy government bonds rather than to sell them as they have done in recent months. These measures could be justified alone on grounds of restoring the functioning monetary transmission channel and the worsened economic outlook. Of course the ECB could do more in response to a successful EU summit, resulting in a credible commitment to a fiscal compact by enough countries (Maastricht 2.0), but unfortunately the EU summit concludes a day after the ECB press conference. What's more, the exact wording of the "fiscal compact" is presently expected only by March 2012. The ECB is therefore likely to hold back with more aggressive measures or to introduce them step by step until it there is more certainty about which scenario materializes ("Rubicon," "effectiveness" or "zero-decision"), although we

Fig. 2: Policy rates of the Fed, ECB and SNB



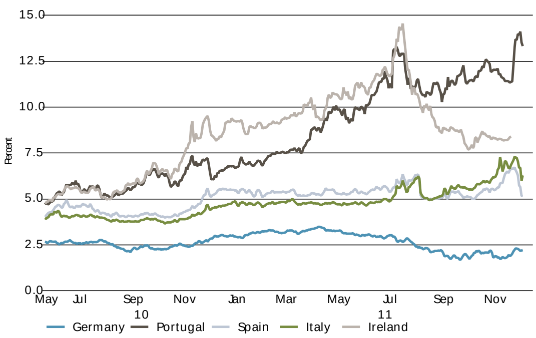
Source: Thomson Reuters, UBS WMR

would expect the ECB to temporarily augment its government bond purchases if market stress increases again.

Impact on Eurozone government bonds

The considerable movement of EMU government bond yields recently, with German ones increasing and Italian and Spanish ones declining, lends substantial credit in the market to the political notion of moving towards a fiscal union, which in our baseline scenario and according to the Franco-German proposal, is not going to happen in the next few years. Therefore, we expect yields to diverge again, and we can imagine Italian yields moving to recent highs again soon, in light of the large refinancing needs scheduled early in 2012. We give little credence to the statements that the Greek private sector involvement (PSI) will be the only case of private sector losses in Europe, as we think Portugal is at risk of moving towards an unsustainable debt situation over the coming years. If this occurred, politicians would need to choose between breaching at least one promise, the protection of private creditors, and the promise that taxpayers will not have to pay for other countries' debt. We maintain our recommendation to avoid European government bonds in general and to sell Portuguese bonds maturing beyond mid-2013. We also keep our cautious stance on European banks in general and on all corporate bond issuers domiciled in the periphery countries, as these cannot effectively de-couple from pressure on their respective government's bonds.

Fig. 3: Government bond yields (10-yr duration)



Source: Thomson Reuters, UBS WMR

Economic impact

Based on our expectation of a full Greek default, pressure on government credit ratings, bank deleveraging and a "wave" of Italian government financing needs between February and April, we see a high risk of a re-widening of bond spreads, which would limit the beneficial economic impact of the measures listed above. In fact, we already pre-empted further monetary easing when estimating the impact of fiscal tightening in 2012 on economic growth. Against this backdrop, we maintain our GDP forecasts and expectation of a mild recession in 2012 in the Eurozone.

Impact on equities

Concerning financial markets, the reactions are likely to vary depending on the category of outcome reached at the EU summit. Global equities advanced by about 10% in the last two weeks. This move, in our view, was driven by better economic data out of the US, but mainly the hope to approach resolution of the sovereign debt crisis. Therefore, a "zero-decision" event would most likely lead to disappointment for equity investors. Recent gains most likely could not be sustained in coming weeks. A defensive positioning with a preference for high dividend yielding stocks as well as a cautious stance on Eurozone financials seems appropriate in such a scenario.

"Effectiveness" would most likely be seen by equity investors as too little (substance). Thus, these measures are not likely to lead equity markets higher on a lasting basis. Come next spring, equity investors will be confronted with huge refinancing needs in Southern European countries and the fact that the Eurozone economies will most likely have entered a recession. Even in this scenario, a defensive positioning with a preference for US over Eurozone equities seems to be appropriate on a three- to six-month view.
"Rubicon" sounds more promising for equity investors. It could remove some of the fears which investors currently have and thereby provide support for equities – especially in the weeks immediately after such an announcement. Therefore, in such a case one should consider adopting a less negative approach to Eurozone equities and also Eurozone Financials. Still, the recession in the Eurozone will be difficult to avoid, and Greece, in our view, will still default in spring next year. The de-leveraging of Financials will continue.

Appendix

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