

Eurobonds and revised IMF facilities are not "it" – but we are getting closer to a powerful crisis response

In this note I'll argue that the Commission's paper on Eurobonds is irrelevant for the immediate crisis management – but that important things are now happening in this space. I suspect that we'll shortly get further liquidity measures from the ECB and that we are getting close to a move to cap sovereign funding costs.

Two independent sets of news have confused some people in recent days: The European Commission's proposal for Eurobonds and the IMF's announcement of revisions to their credit lines. Importantly, none of these two events should be seen as part of the crisis response being prepared elsewhere. I'll first briefly touch on the two announcements before moving on to the more important issue of crisis management where something may be cooking:

The Commission has published its long awaited – and already leaked – paper on three possible types of Eurobonds. They were asked some time ago by the Council to spell out how Eurobonds might be structured, if they ever were to be introduced. There is no recommendation in the paper and the decision whether to go down this route – or not - will be taken unanimously by the Council; i.e. by the governments. "Proper" Eurobonds (i.e. with joint and several guarantees) would be a step in the direction of a fiscal union because – assuming that the yield would reflect some sort of weighted average - some would pay more for their debt than at present while others would pay less, and that would imply a fiscal transfer from the former to the latter. Not surprisingly, countries in the former group are opposed to Eurobonds at this stage, while some of those in the latter group have expressed interest. Importantly, Germany has not completely shut the door on Eurobonds, but Merkel has made it clear that the first priority (indeed a condition) would have to be a change to the treaty which would see everyone surrender a degree of sovereignty over certain areas of fiscal policy, something she has said Germany might support – boldly putting the ball in the court of potentially receiving countries (from where there has been no official response yet). Once the treaty has been changed – i.e. some version of political union has been introduced – one could imagine the introduction of Eurobonds. Importantly, however, this is not a crisis response, but an interesting suggestion for one (actually rather minor) aspect of the long term future of the Euro-zone.

Separately, the IMF announced earlier this week that they have revised their lending instruments to include a "Precautionary and Liquidity Line" and a "Rapid Financing Instrument". The PLL can be used as a liquidity window for qualifying countries (i.e. those having good policies etc in place already) for a six months period for an amount of up to 500% of quota in exceptional circumstances. The RFI "broadens coverage of urgent balance of payments needs beyond those arising from natural disasters and post-conflict situations, and can also provide a framework for policy support and technical assistance".

Erik F. Nielsen
Global Chief Economist – UniCredit Group
+44 207 826 1765
erik.nielsen@unicredit.eu

Bloomberg:
UCGR, UCFR

Internet:
www.research.unicreditgroup.eu

In other words, the PLL could be used in the European periphery, but – just as has become evident with respect to the EFSF – the amounts available would be unlikely to make an impact on markets, given the present environment of (misguided) fear.

Importantly, one should not confuse these measures with the need for a crisis response to the present situation – and by the same logic, that response should not become institutionalized for the longer term structures of the Euro-zone.

There are four possible outcomes for the present crisis:

- Markets gradually regain "sanity" and begin to appreciate the real adjustments taking place in the Euro-zone periphery. One could imagine this happening during Q1 or Q2 as/if the economy begins to show some stabilization and as what appears to be temporary technical factors come to an end (including bank selling in response to the need to mark to market their bank books by mid-2012; banks selling as they have new doubt whether their CDS hedges are worth anything; and investors re-assess their risk aversion after the end of this horrible year.) It is anybody's guess what the probability is of this scenario playing out. Personally, I think it is relatively low primarily because investors' incentive function has become so skewed that it'll take a shock intervention to change the odds.
- The authorities bring out the bazooka via either adding another huge amount to the EFSF (a trillion?) or they give the EFSF a banking license so that they can repo at the ECB. The former seems impossible; the latter somewhat likely particularly as France and others are pushing. I have written on this before; I think it would be a good idea, but I don't see much move in this direction among key policymakers.
- The ECB gets aggressively and intervenes heavily and persistently, and/or they announce a temporary ceiling for the funding cost for countries in full compliance with the Troika's policy demands – and they back it up with interventions, if needed. I think we are heading in this direction – and soon!
- The ECB decides that they have reached a (non-existent) limit for the SMP, steps away – and we'll be heading for a default in not one but several major countries (and the ECB's reputation would be destroyed!) I continue to assign an extremely low probability to this scenario.

So, how will it play out? My guess is that the authorities, including the ECB, still hope for the first scenario to play out, but that they recognize the increasing – and indeed significant - risk associated with the time it may take to play out. To reduce the risk of a big accident, I suspect that they'll shortly buy some insurance via further liquidity measures – longer and more flexible money - for the financial system.

Meanwhile, they must be consulting with the political leaders, laying out the four options, and – with the leaders' limited enthusiasm for a bigger and more powerful EFSF – they must now be formulating possible narratives for capping sovereign funding costs. And this is not an easy task by any stretch of the imagination. One very important issue is moral hazard: How do you secure full implementation of any agreed program once you have announced a cap? A conditional cap would not be as effective as an unconditional one, and it could become very expensive for the ECB to implement. In contrast, an unconditional (but time limited) cap might be completely free of charge, but then you really have to trust the leadership of the recipient country.

And then it strikes me how good it is to see that Merkel, Sarkozy and Monti will be meeting tomorrow in Strasbourg!

Stay tuned.

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Regulatory authority: CNB Czech National Bank, Na Příkopě 28, 115 03 Praha 1, Czech Republic
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Regulatory authority: Polish Financial Supervision Authority, Plac Powstańców Warszawy 1, 00-950 Warsaw, Poland
- k) UniCredit Bank, Prechistsenskaya emb. 9, RF-19034 Moscow, Russia
Regulatory authority: Federal Service on Financial Markets, 9 Leninsky prospekt, Moscow 119991, Russia
- l) UniCredit Bank, Šancova 1/A, SK-813 33 Bratislava, Slovakia
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- n) UniCredit Tiriac Bank, Ghetariilor Street 23-25, RO-014106 Bucharest 1, Romania
Regulatory authority: CNVM, Romanian National Securities Commission, Foişorului street, no.2, sector 3, Bucharest, Romania
- o) ATFBank, 100 Furmanov Str., KZ-050000 Almaty, Kazakhstan
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UniCredit Research*

Thorsten Weinelt, CFA
 Global Head of Research & Chief Strategist
 +49 89 378-15110
 thorsten.weinelt@unicreditgroup.de

Dr. Ingo Heimig
 Head of Research Operations
 +49 89 378-13952
 ingo.heimig@unicreditgroup.de

Economics & F/FX Research

Erik F. Nielsen, Global Chief Economist
 +44 207 826 1765
 erik.nielsen@unicredit.eu

Economics & Commodity Research
European Economics

Marco Valli, Chief Eurozone Economist
 +39 02 8862-8688
 marco.valli@unicredit.eu

Andreas Rees, Chief German Economist
 +49 89 378-12576
 andreas.rees@unicreditgroup.de

Stefan Bruckbauer, Chief Austrian Economist
 +43 50505 41951
 stefan.bruckbauer@unicreditgroup.at

Tullia Bucco
 +39 02 8862-2079
 tullia.bucco@unicredit.eu

Chiara Corsa
 +39 02 8862-2209
 chiara.corsa@unicredit.eu

Dr. Loredana Federico
 +39 02 8862-3180
 loredana.federico@unicredit.eu

Mauro Giorgio Marrano
 +39 02 8862-8222
 mauro.giorgiomarrano@unicredit.eu

Alexander Koch, CFA
 +49 89 378-13013
 alexander.koch1@unicreditgroup.de

Chiara Silvestre
 chiara.silvestre@unicredit.eu

US Economics

Dr. Harm Bandholz, CFA, Chief US Economist
 +1 212 672 5957
 harm.bandholz@unicredit.eu

Commodity Research

Jochen Hitzfeld
 +49 89 378-18709
 jochen.hitzfeld@unicreditgroup.de

Nikolaus Keis
 +49 89 378-12560
 nikolaus.keis@unicreditgroup.de

EEMEA Economics & F/FX Strategy

Gillian Edgeworth, Chief EEMEA Economist
 +44 0207 826 1772, gillian.edgeworth@unicredit.eu

Gyula Toth, Head of EEMEA F/FX Strategy
 +43 50505 823-62, gyula.toth@unicreditgroup.at

Güldem Atabay, Economist, Turkey
 +90 212 385 9551, guldem.atabay@unicreditgroup.com.tr

Hans Holz hacker, Chief Economist, Kazakhstan
 +7 727 244-1463, h.holz hacker@atfbank.kz

Marcin Mrowiec, Chief Economist, Poland
 +48 22 656-0678, marcin.mrowiec@pekao.com.pl

Rozália Pál, Ph.D., Chief Economist, Romania
 +40 21 203-2376, rozalia.pal@unicredit.ro

Kristofor Pavlov, Chief Economist, Bulgaria
 +359 2 9269-390, kristofor.pavlov@unicreditgroup.bg

Goran Šaravanja, Chief Economist, Croatia
 +385 1 6006-678, goran.saravanja@unicreditgroup.zaba.hr

Pavel Sobisek, Chief Economist, Czech Republic
 +420 2 211-12504, pavel.sobisek@unicreditgroup.cz

Dmitry Veselov, Ph.D., Economist, EEMEA
 +44 207 826 1808, dmitry.veselov@unicredit.eu

Vladimír Zlacky, Chief Economist, Slovakia
 +421 2 4950-2267, vladimir.zlacky@unicreditgroup.sk

Global F/FX Strategy

Michael Rottmann, Head
 +49 89 378-15121, michael.rottman1@unicreditgroup.de

Dr. Luca Cazzulani, Deputy Head, FI Strategy
 +39 02 8862-0640, luca.cazzulani@unicredit.eu

Chiara Cremonesi, FI Strategy
 +44 20 7826-1771, chiara.cremonesi@unicredit.eu

Elia Lattuga, FI Strategy
 +39 02 8862-2027, elia.lattuga@unicredit.eu

Armin Mekelburg, FX Strategy
 +49 89 378-14307, armin.mekelburg@unicreditgroup.de

Roberto Mialich, FX Strategy
 +39 02 8862-0658, roberto.mialich@unicredit.eu

Komelius Purps, FI Strategy
 +49 89 378-12753, komelius.purps@unicreditgroup.de

Herbert Stocker, Technical Analysis
 +49 89 378-14305, herbert.stocker@unicreditgroup.de

Publication Address

UniCredit Research
 Corporate & Investment Banking
 UniCredit Bank AG Milan Branch
 Economics & F/FX Research
 Via Tommaso Grossi, 10 - 20121 Milan
 Tel +39 02 8862.2019 - Fax +39 02 8862.2585

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