

# DEAL OR NO DEAL?

Christmas, it is said, comes but once a year. Sadly, the same can't be said of 'comprehensive and global' solutions to the Eurozone's sovereign-debt crisis. Like Christmas, the latest agreement arrived far sooner than anyone expected. The hope is that it will lay the foundations for a 'fiscal and stability union' in the Eurozone. Angela Merkel, Nicolas Sarkozy and Mario Draghi, head of the European Central Bank, all seem happy. The bond market, however, proved largely immune to the festive cheer emanating from Brussels, where 17 Eurozone leaders thrashed out the agreement. Moody's was in similarly Grinch-like mood, greeting the news by downgrading BNP Paribas, Société Générale, and Crédit Agricole. So before we pull a cracker and raise a festive toast to the deal, a few questions need to be answered...

**Does the deal solve the Eurozone's debt crisis?** No. But it wasn't designed to. Instead, the real question is whether it will convince Germany that the European Central Bank should act to ease the crisis in the bond market. The assumption is that because Germany and the ECB have what they want – commitments on the part of reckless borrowers on the periphery to balance their budgets – they will do whatever is necessary to ensure the Euro's survival. The idea is that, backed by Germany's AAA credit rating, the ECB will start printing Euros and buying debt issued by Italy, Spain, Portugal, etc., in sufficient quantities to shock the bond market into submission. The danger, of course, is that if the ECB doesn't act, then disappointed bond traders could resume dumping peripheral Eurozone debt, putting the Euro – and the European banking system – under renewed pressure.

**Will it work?** The deal focuses on deficits, reflecting the conventional wisdom that the Eurozone's debt crisis is a result of out-of-control spending. Sadly, deficits aren't the Eurozone's only – or even its main – problem. The current crisis is as much about economic growth as it is about deficits. For example, Spain's gross debt to gross domestic product ratio is 67% while France's is 81%. In contrast, Canada's ratio is 84% and the US sits at a cool 100%. There is, however, no Canadian sovereign-debt crisis. Britain, the US and Canada can all borrow from the bond market for 10 years for modest yields of around 2%. Spain pays more than double that. In part, then, the high yields on debt issued by weaker European countries reflect the market's worries that continuing slow growth – or even recession – could eventually make those debt burdens unsustainable. By placing strict limits on government spending it could trigger a new age of austerity. Deeper spending cuts and higher taxes could actually serve to shrink the economies, thereby raising their debt-to-GDP ratios. Viewed in this light, the deal reached in Brussels on Thursday night does nothing to address southern Europe's debt problems, which are inextricably bound up with its lack of growth. In fact, the deal could prove counterproductive.

**Can it be enforced?** No. For those who are more worried about economic growth than they are about deficits, there is a silver lining to the Eurozone's latest deal: it has no teeth. Because the UK refused to sign off on the deal, the existing EU treaty can't be used to enforce its provisions. And because EU institutions such as the European Commission cannot have a formal role in any agreement that takes place outwith EU treaties, the deal currently lacks a credible enforcement mechanism. In fact, it is unclear how this deal differs from the earlier (and universally derided) Stability and Growth Pact. So while Eurozone countries can promise to aim for prudent, balanced budgets based on the German model they are at liberty to change their mind should economic conditions deteriorate sufficiently to make further helpings of austerity look like a bad idea.

Of course, if the optimists are right (and let us hope that they are) and economic growth in Europe does pick up, then perhaps Eurozone borrowers will abide by Germany's prudent budgetary rules. In the long term, however, it will be economic growth that will decide whether the Eurozone survives in its present form. Europe's leaders might have made a deal but they haven't found a solution.

12 December 2011

The views expressed in this article are the writer's own and do not necessarily reflect those of the 7IM Investment Team.

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