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The eurozone crisis is on pause, not over

By Wolfgang Münchau

You have to give it to the European Council. They are pretty good at stitching up impressive looking deals, having lowered expectation to a bare minimum beforehand. But the effectiveness of an agreement should not be gauged by the immediate market reaction, let alone by how the agreement compares with expectations.

For it to be a positive contribution to the eurozone debt crisis, it should meet three tests. Will it put Greece on a path towards sustainable debt reduction? Will the new rules for the European financial stability facility make contagion less likely? And is the participation of private investors realistic and fair? My answer to those three questions would be, respectively: no, no, and yes.

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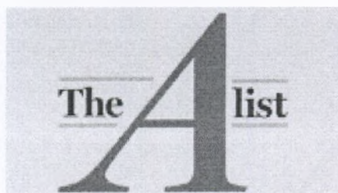

Contributors include Lawrence Summers, George Soros, Mohamed El-Erian, Nouriel Roubini, Francis Fukuyama, Mario Monti, Jim O'Neill and Laura Tyson

Regarding the first question, the Institute of International Finance estimated the total reduction in the net present value of Greek debt to be 21 per cent. Nicolas Sarkozy, the French president, talked about a 24 percentage point reduction of the ratio of debt to gross domestic product. His is a more conservative estimate. In other words, the Greek debt-to-GDP ratio would not peak at 172 per cent, as one forecast suggested, but at 148 per cent. None of these numbers will come even close to a sustainable debt level. On my own calculations, Greece requires a reduction in the net present value of its debt by about 50 per cent. This agreement comes short.

With the private sector contribution now fixed, any future reduction in the value of Greek debt would have to come from an increase in the maturity of the official Greek loan. I have no doubt that a portion of the debt will ultimately need to be folded into a eurozone bond. Officially, the European Union is still pursuing a variant of plan A – that Greece will be able to repay its debts in full. Its adjustment plan for Greece remains full of unbridled optimism.

An integral part of the Greek package is a €30bn provision for privatisation receipts by 2014, which is plainly ludicrous. This and other gaps will need to be plugged. That means that the refinancing need will be higher, and the reduction in the net present value lower.

I wonder, therefore, whether it was worthwhile to risk a selective default for such a meagre debt reduction effort? EU negotiators persuaded themselves that they were able to control the fallout from a default. But that was dependent on the default being a limited one. At the same time, the scale of the private sector participation needed it to be sufficiently large to satisfy the eurosceptics in the German, Dutch and Finnish parliaments. This was no doubt a compromise

that works politically. But it comes at the expense of debt sustainability. Even before the ink on this second package is dry, a third Greek package beckons. I am just not sure what the German and the Finnish sceptics will say when they find out.

Regarding the second question: has the agreement made life any safer for Spain and Italy? The idea of providing the EFSF with more flexibility is good. The rule changes are by far the most interesting aspects of the agreement. At present, the EFSF can only grant credits. Under the new rules, it will be able to act pre-emptively. Like the International Monetary Fund, it will have a flexible credit line. It will be able to purchase bonds on secondary markets, and it will be able to recapitalise banks. It can do all of these for any eurozone country, even those that are not part of an ordinary EFSF programme.

But there is a catch. The European Council did not raise the EFSF's lending ceiling of €440bn. It is large enough to handle its three peripheral customers, but not Spain and Italy. An enlargement would have been necessary for the new-found flexibility to have any practical use. Should Italian bonds come under pressure again, do we really believe that speculators would be scared by a stability mechanism with a fixed and transparent spending ceiling?

The EFSF also remains constricted by its own operating rules. It can only start a programme of purchases on the advice of the European Central Bank, and it requires a unanimous vote by its members.

The best news relates to the decision on private sector participation. It is good that the eurozone has come to closure in this tedious debate. The terms of the various debt exchange offers are still bank-friendly, but not nearly as cynical as some of the earlier proposals. Contrary to what the European Council said, the private sector participation will be a blueprint for bail-outs that are yet to come. Second Irish and Portuguese programmes are likely. The northern Europeans will once again demand private sector participation. Now they know how it can be done, they will want to apply the same rules in the future.

Thursday's agreement succeeded in staving off an imminent collapse of the eurozone. That is undoubtedly its greatest achievement. But we should not fool ourselves. It will only succeed if it is followed by other agreements that fix its gaps. The new EFSF rules will only make sense if the rescue mechanisms are allowed to develop into a European debt agency. The second loan package to Greece will be fine as long as we realise that there needs to be a third.

When the Europeans return from their holidays, they will still have the euro – and they will still have the crisis.

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