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95

Eurozone firewall talk fails to quell fears

By Richard Milne

To listen to many eurozone policymakers, one would imagine all is now well with their two-year long struggle with the sovereign debt crisis.

Progress on plans for a beefed-up "firewall" to bail out distressed countries, which now have Germany's backing, are cited in support.

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Not so fast, say the markets. Sure, everyone is agreed that things feel better than they did at the end of last year. But many investors also say that little has changed fundamentally.

A good example of that is the apparent willingness of Germany and Finland to allow the temporary eurozone rescue vehicle, known as the European financial stability facility, to run alongside the soon-to-be-launched permanent one, the European stability mechanism. But a headline lending figure of €940bn for the two soon fizzles out as at least €200bn is already committed and the EFSF's €440bn is likely to end next year.

"I don't see the eurozone crisis fading in the next few years even when the ESM is operating," says Neil Williams, chief economist of Hermes. Like many, he believes that even in enlarged form the rescue funds would be unable to deal with either Spain or Italy, the two Mediterranean countries whose fiscal and economic health is still viewed as critical to whether the crisis takes off again or not.

The market responded positively on Monday to the news of a breakthrough on the "firewall", despite the worries about its effectiveness. Spanish benchmark 10-year yields, which have come under pressure in recent weeks and move inversely to prices, fell 8 basis points to 5.32 per cent and their Italian equivalents fell 2bp to 5.02 per cent.

Robert Crossley, head of European rates strategy at Citi, describes the agreement to let the EFSF and ESM run in parallel as a small bit of good news: "It is mildly positive because it could have been worse or not have happened at all. Everybody knows it is not going to be big enough. But less inadequate is a good thing."

The bond market's concern is once again centred on Spain. After a long time in which Spain's yields had significantly outperformed Italy's, the mood has swung against Madrid this year. Italy's 10-year yields have fallen 187bp in 2012 while Spain's have risen 22bp.

Some attribute this to the attempt by Mariano Rajoy, Spanish prime minister, to flout European Union rules by unilaterally relaxing his budget deficit target from 4.4 per cent to 5.8 per cent. After a compromise deal with Brussels, the goal was adjusted to 5.3 per cent.

As concern over Spain's public finances has increased, Spanish 2-year yields have this month risen almost 30bp. Still, Madrid has raised more than 40 per cent of its total financing needs this year as it benefits from domestic buying after the European Central Bank's longer-term refinancing operations (LTROs), under which €1tn has been lent to eurozone banks at very low rates. That has underpinned sovereign bond markets as well as averted a credit crunch.

Jim Leaviss, head of retail fixed income at M&G Investments, like many in the market, struggles to make sense of the saga over the parallel rescue funds. He says: "Nobody really knows [about the impact of the EFSF combined with the ESM]. What we do know is that the eurozone remains insolvent. Growth is still a problem."

Mr Williams worries the core eurozone countries are being subtly hit. He uses a variant of the misery index – combined rates of unemployment and inflation – over two decades to show the eurozone average is rising. "There is convergence but it is on the weakest. Increasingly it is the bigger countries paying the bill."

German 10-year bond yields on Monday rose 8bp, though at 1.95 per cent remain subdued by historical standards. However, 10-year yields for the Netherlands – no longer part of the core, according to Citi – have risen 50bp off their January lows while Bunds have added only 19bp. Economic growth across much of the eurozone is still a worry.

For some, however, what is remarkable is how sanguine markets appear to be about recent developments. Spain's disclosure that its deficit would be far higher than agreed with European authorities was met by unease from investors but no big sell-off.

One reason for this may be that the ECB has shown it is willing to act should the crisis deteriorate further.

Mr Crossley says: "If you had looked at this six or 12 months ago people would have been petrified ... The mood change in markets is the most important thing. It doesn't mean that the problems have magically evaporated but the market is a lot happier."

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