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Markets rebound after eurozone deal

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By Hugh Carnegy, Peter Spiegel and Quentin Peel in Brussels

Financial markets rebounded strongly on Friday after European leaders struck an unexpectedly detailed deal to help Spain and Italy face down fears about their ability to survive the eurozone crisis.

The agreement to allow the eurozone's rescue funds to recapitalise Spain's enfeebled banks directly and to buy Italian sovereign bonds sparked the biggest daily rise in European stocks, Italian and Spanish bond prices and the euro/dollar exchange rate this year.

A key element of the deal was the introduction of a new system of European banking supervision via the European Central Bank, a first step towards a full banking union. The leaders also agreed a €120bn package of growth promotion measures and the start of negotiations to closer fiscal and economic co-operation.

The euro rose 2 per cent at one point, finishing up 1.7 per cent at $1.27 at the London close. Yields, which have an inverse relationship with prices, on Spanish 10-year bonds fell 62 basis points to 6.32 per cent, well below their recent peaks above 7 per cent, the level at which other eurozone countries have required international bailouts.

Italian 10-year bond yields were down 38 basis points at 5.81 per cent.

Wall Street's S&P 500 index rose 2.5 per cent in its best daily performance since the start of the year. The rally helped US stocks end the month 3.9 per cent higher, although over the quarter the index was down 3.6 per cent.

European stock markets rose sharply. The FTSE Eurofirst 300 rose 2.64 per cent to 1,021.39. The Italian and Spanish stock markets jumped 6.59 and 5.66 per cent respectively.

The deal was done in customary EU style in the early hours of the morning at a summit meeting in Brussels after intense negotiations. Mario Monti, Italy's prime minister, led a concerted effort with Mariano Rajoy, his Spanish counterpart, and supported by President François Hollande of France, to force Angela Merkel, the German chancellor, to accept the need for short-term measures to tackle the debt crisis.

Mr Hollande said: “Nobody should say I won or I lost. It is Europe that was at stake and it is Europe that won, and it is the eurozone that has been strengthened and reinforced and that was the sole aim.

“If Italy and Spain applied pressure during the night it was so that the whole eurozone would come out stronger.”

Ms Merkel flew home later on Friday to face a stormy meeting of the Bundestag concerned about the concessions she had made. The parliament held a key vote to approve the fiscal discipline treaty agreed at an earlier summit and the setting-up of the European Stability Mechanism, the eurozone’s new €500bn rescue fund.

A top German concern was that the agreement to allow the ESM and its predecessor, the €440bn European Financial Stability Facility, to inject capital directly into Spanish banks would expose German taxpayers backing the rescue funds to highly risky financial institutions.

Ms Merkel insisted that German taxpayers’ money would not be committed without strict conditions.

“I insisted that the current procedures should be maintained, and I think we found a good compromise,” she said.

The deal on Spanish banks, set to receive up to €100bn, will allow Spain to recapitalise the sector without increasing the level of Spanish sovereign debt – breaking a “vicious circle” of convergence of banking and sovereign debt that weighed heavily on financial markets.

Aid will initially be made by the EFSF until being transferred to the ESM when it comes into force next month, But under the deal, loans to Spanish banks will not then acquire “seniority status” that would push private sector bondholders down the repayment pecking order, as ESM rules dictate, easing another key financial market concern.

In a concession sought by Mr Monti, the agreement should make it easier for a stricken government such as Italy to enlist the ESM to buy its bonds, so reducing sovereign borrowing costs.

“Italy does not plan to activate the mechanism for now, but I do not exclude anything for the future,” Mr Monti said.

Ms Merkel said the commitment to use the rescue funds to buy sovereign bonds would still be subject to conditionality. A country such as Italy would have to apply for such action and sign a memorandum of understanding based on the European Commission’s recommendations.

The leaders also agreed that Ireland, which has already accepted a bailout, should have access to the same terms offered to Spain. Enda Kenny, Ireland’s prime minister, hailed the move as a seismic shift in EU policy.

"What was deemed to be unachievable has now become a reality and that principle has been established and decided and agreed upon by the council, by the heads of government."

Apart from the financial stability measures, the summit agreed a €120bn "growth pact" aimed at giving a boost to Europe's flagging economies. In a key German demand, the leaders committed to negotiate steps towards establishing a fiscal union for the eurozone, including full banking and budgetary union, closer economic policy co-ordination and enhancing democratic legitimacy.

Mr Hollande said he was now prepared to present the package to the French parliament, including the fiscal discipline treaty, which he had previously insisted must be renegotiated.

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