

# Eurozone rescue package: one step forward, two steps back

## BEHIND THE NUMBERS

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Relief from the eurozone agreement was short-lived

Eurozone banks still face a 9% capital requirement, which will be achieved through a reduction in lending

The long-awaited eurozone rescue package emerged in the early hours of 27 October and, as far as we could make out, consisted of nothing that had not already been well leaked the previous weekend.

Furthermore, any detail on how the various initiatives were going to be achieved was also singularly lacking, particularly on how the EFSF was going to be expanded by €1 trillion.

The only word that kept being applied to this expansion was “leverage”, which is about the last concept that needs to be applied to a eurozone-wide debt crisis.

However, there was no doubting that the initial reaction to the announcement was very positive, with risk being avidly purchased on the first two days that followed, but we suspect that this was driven as much by sheer relief that a concerted effort was made to show serious intent in dealing with the crisis as by the actual measures that were announced.

We also suspect that some markets, notably equities, were driven as much by the much better-than-expected US GDP figures.

Unfortunately, relief proved



↑ Protesters demonstrate against austerity measures linked to the Greek government's inability to pay its debts

short-lived. At the beginning of this week, the combination of the MF Global bankruptcy and Greek premier Papandreou's shock announcement of a referendum to allow the nation to decide between a further decade of austerity, or total default and exit from the eurozone, proved far too much for the markets' nerves.

The previous week's “risk-on” trades were very hastily unwound as investors fled for the safety of AAA-rated government debt. The feeling was one of having taken one step forward and two back.

### Capital requirement

Another main focus of attention has been on the banks being able to meet their 9% capital requirement after having allowed for the 50% haircut on Greek government debt. Clearly, the banks had been pressing for a lower figure, but they had no choice but to accept when the alternative was to have been blamed for the breakdown of the restructuring talks.

The figures being bandied around that the banks will have to find in order to meet the requirement had been as high as €200bn (£172.6bn) with those domiciled in Greece, who will probably need to be nationalised, soaking up €30bn on their own. There are, therefore, some doubts over the

announced €105bn being sufficient to cover the whole sector.

However, the real attention is on how the major eurozone banks will manage to achieve the capital requirement. It is almost impossible to believe that raising equity at current market levels would represent anything other than an act of desperation when all else has failed.

The method favoured by all the major banks will be to shrink. This will be achieved through reducing their lending activities and, as far as possible, retaining earnings through reducing costs.

This is hardly a prospect that engenders much confidence for the growth of the eurozone economy even if most of the major eurozone banks think this will allow them to meet the capital requirements by June next year. The UK banks, of course, either do not have a major exposure to Greece or have already written it down to 50% or less.

At the time of writing, the focus of attention had passed on to the G20 meetings to be held in Cannes on 3 and 4 November. While these are supposed to focus on global issues, much attention will still be concentrated on the eurozone debt rescue package and some of its more elusive issues,

particularly the basis on which the EFSF can be increased.

There has, however, been plenty going on this week away from the G20 meeting. By the time of publication, the ECB will have met to decide whether to cut rates in response to the rapidly weakening eurozone economy.

This will have been the first meeting to be chaired by Mario Draghi following Jean-Claude Trichet's retirement. At the last ECB meeting, Trichet paved the way for a cut this month, but many commentators have been of the view that action so soon after the latest rescue package might be inappropriate.

### Hawkish credentials

Readers will by now know the answer to the conundrum of whether Draghi will have wanted to establish his hawkish credentials with the Germans by resisting the call for a cut and waiting until later this month when it could be seen to be achieved under his authority, or will have had the self-confidence to cut rates, knowing the criticism to be suffered as a result.

The focus for the future will be on the eurozone and whether the optimism generated by the rescue package can be reestablished and, more importantly, sustained.

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