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The Eurozone crisis explained

The issues facing the EU summit

- **The problems**
- **The consequences of a Eurozone break-up**
- **The possible solutions**

The European sovereign debt crisis affects investors everywhere. A drama that began in Greece spread first to Ireland and Portugal, and more recently to Spain and Italy. Keeping the Eurozone together will involve huge financial resources and considerable ingenuity. The alternative would be worse. We argue that a break-up of the euro would be a disaster and in a worst-case scenario could trigger another Great Depression.

But the crisis is hugely complex. A great many issues, politicians, states and supranational organisations are involved, and there are a host of confusing acronyms. Many investors are struggling to keep up with the latest developments in this fast-moving story.

The current situation is this: amid growing concern that Greece is heading for a default, European leaders are attempting to prevent the contagion spreading to larger economies such as Italy and Spain, and to ensure that the region's banks have enough capital. But many issues remain unresolved – how private sector creditors will share Greece's pain, what measures will be politically acceptable for the Eurozone's 17 very different countries and what role should be played by both the European Central Bank and the European Financial Stability Facility (EFSF), the Eurozone bail-out fund.

As Jean-Claude Juncker, the prime minister of Luxembourg and an important player on the European stage, put it: "We all know what to do but we don't know how to get re-elected once we have done it."

The uncertainty has resulted in a flight from risk, hitting stock and bond markets in the US, Europe and emerging markets, where currencies have also suffered. That's why the meeting of European leaders in Brussels on Sunday (23 October) is so crucial.

Recent developments have highlighted the fact that the Eurozone has a unified monetary policy, but not a unified fiscal regime. It has shown comprehensively that credit risk did not disappear with currency risk at the time the euro was created.

This report summarises the recent work of our leading economists and fixed income strategists. It explains how the crisis started, the consequences of a Eurozone break-up, possible solutions and looks at what is likely to happen next. We list the institutions and major players involved in the discussions and give key dates and acronyms.

This report summarises recent HSBC publications including – *How to solve the euro's problems* by Stephen King and Janet Henry (30 September), *Eurozone solution bad for Bunds* by Steven Major (7 October) and *Eurozone Sovereign Debt Crisis* by Steven Major (18 October).

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The problems

- Currency risk disappeared in the Eurozone in 1999
- The northern European nations have since offered the weaker nations at the periphery temptation after temptation
- If the creditor and debtor nations can't agree on how the burden of the economic shock should be shared, financial anarchy beckons

A 10-step guide to how Europe got into this mess

1 The euro's creation in 1999 removed cross-border currency risk between the member states of the Eurozone. Assets and liabilities could be matched across nations like never before. German investors could own Italian assets and Spanish investors could own French assets without risk of currency loss. With the flick of a euro switch, currency risk disappeared.

2 The euro's arrival couldn't have been more perfectly timed. Italy and Spain both offered deep and liquid bond markets. Yields on so-called "peripheral" debt were marginally higher than yields in the core countries. In the absence of currency risk, it made perfect sense for the Germans, the Dutch and others to head south. Within the Eurozone, yield prospectors had apparently struck low-risk gold.

3 The Chinese economy was expanding at a rate of knots, but was at the same time running a large current account surplus which, in dollar terms, was only getting bigger. China's buying power over foreign assets thus increased hugely. Its foreign exchange reserves went through the roof. Because reserves were mostly invested in liquid dollar paper, the global risk-free rate was pushed lower, leading to the revaluation of a whole host of fixed income assets, thus providing a further catalyst for northern European investors to succumb to southern temptations.

4 With the formation of the euro, European government bonds were suddenly treated as if they were risk-free. To join the Eurozone, countries had to meet the so-called convergence criteria. As is now widely known, many seemingly non-convergent countries back in 1999 were given the benefit of the doubt. Italy, for example, joined the euro with a debt/GDP ratio some 55 percentage points higher than the 60% threshold. Yet even if the criteria had been strictly adhered to, subsequent developments reveal that the criteria were – and, indeed, still are – next to useless.

5 Convergence on fiscal policy, inflation and interest rates was all very well, but no real effort was made to find out whether there had been any convergence on competitiveness. The nations on the periphery of the eurozone have, in some cases, lost a massive amount of competitiveness whereas Germany has performed handsomely.

6 The northern European nations offered the periphery temptation after temptation. It wasn't as if the southern nations demanded to live beyond their means. Borrowing on a reckless scale would presumably have led to much higher interest rates on southern debt yet, in the early years of the euro, this was manifestly not the case. Interest rate spreads converged as the surpluses generated by Germany were recycled into real estate booms in Spain and elsewhere. The growing imbalances were as much the fault of the creditors – northern European financial institutions and their regulators – as of the debtors.

7 The rot set in with the onset of the 2008 financial crisis. The years of economic stagnation that followed left countries with lower growth and governments short of revenue. In 2009, the incoming Greek government was forced to admit that, under the previous regime, the fiscal books had been 'cooked'. And banks, in turn, discovered that, in an environment of economic stagnation, supposedly good assets were rapidly turning bad.

8 The perfect storm which followed revealed an underlying problem within the eurozone which, in the early years, had been totally forgotten. Before the euro's creation, European countries facing an unsustainable fiscal position could resort to the use of the monetary printing press. This was a form of "stealthy" default and this option no longer exists.

9 Today's troublesome debt dynamics are not just the result of profligate behaviour in the periphery. They are, most obviously, a reflection of the impact of the 2008 financial crisis on the level of economic activity. In Italy's case, for example, the level of real GDP is now more than 9% lower than was forecast by consensus at the beginning of 2008. And with GDP so much lower than expected, the ability to repay debts has been seriously impaired.

10 While the Greek situation is the headline news, the problem runs much deeper. The creditors demand their money back and, hence, insist that the debtors deliver the necessary austerity. At the same time as their economies have succumbed to austerity, so borrowing costs have risen. All the while, the incentive for the debtor nations to default only increases. The biggest single problem in providing any kind of resolution to the euro's difficulties is the absence of proper coordination between the euro's 17 member states. If the creditor and debtor nations cannot agree on how the burden of the economic shock should be shared, financial anarchy beckons.

Euro exit – could it happen?

Can a country be forced to leave the euro?

- There is nothing in the Treaty that can be used to force a country out of the euro or can facilitate it but if a country decides that the degree of austerity and reforms have become impossible to deliver and unilaterally decides to leave, it can't be prevented. But euro exit would almost definitely mean EU exit and the free movement of labour, capital and trade that it implies as well as access to EU social and cohesion funds.

What would happen to the exiting country?

- The assets and liabilities of the banking system would, most likely, be redenominated at a rate of one-to-one with a view to a quick depreciation.
- Capital controls would have to be put in place both because of the still large current account deficit and to limit daily cash withdrawals in order to avert a collapse of the banking system which would no longer have access to ECB liquidity. If a euro exit were in any way anticipated the bank runs would have already happened.
- Default would not eliminate the need for fiscal adjustment as primary balance is still in deficit so overnight even more austerity would have to be delivered than under the Troika plan. Assuming this is politically unfeasible, the central bank would undertake debt monetisation.
- Increased likelihood of defaults by companies now holding FX debt, which would also result in a raft of legal challenges in creditor nations.
- With no nominal anchor, there would most likely be a wage-price spiral (especially if the central bank is printing money) which would quickly eliminate any competitiveness gains unless it undertakes massive structural reforms.
- Very hard to reinstate a legacy currency (probably become euro-ised, particularly in the tourism sector and the large informal sector).
- Technical hurdles would be huge: legal, computer codes would have to be rewritten, ATM machines reprogrammed, etc.
- Would have to leave the EU and could face the imposition of trade tariffs from its members.

For the rest of the Eurozone

- Huge contagion to other peripheral countries given that a precedent has been set for a country to leave: bond spreads blow out as foreign investors flee, widespread runs on banks which will have also suffered a credit event.
- The ECB has to respond with vast liquidity provision and government bond purchases as the EFSF would not be able to issue debt quickly enough to make the necessary purchases.
- ECB and all private sector and official creditors would have to completely write off their debt claims on the exiting country. The IMF would likely be the exception given its preferred creditor status and because its assistance may be sought again soon.
- A full-blown credit crunch on a scale that would make 2008 seem mild and economy falls into a deep recession.
- Member state governments could seek recourse under English Law for the loans extended under the bailout package.

What about Germany leaving?

- Political commitment.
- FX appreciation: impact on Germany's export performance. Since the euro was created, Germany has managed to maintain much more competitiveness than ever before. The recent appreciation of the CHF has shown the damage that having a freely floating hard currency can do to an economy, particularly one with an export-led growth model.
- It would amount to a devaluation of external assets of German households, companies and banks.
- Banks would have to be recapitalised because their foreign assets denominated in euros would be worth less.
- Germany would have to leave the EU – it is highly unlikely that the euro could survive the departure of the major economy.

Bottom line: the Eurozone was always a political project and has never been an optimal currency area in terms of structure or country membership. Several member states would be in a better situation now if they had never joined but the implications of beak-up would be potentially catastrophic. It now requires a political solution to make it more of an optimal currency area, involving fiscal integration.

Source: HSBC

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The consequences

- The stakes are enormous: a break-up would mean a collapse of cross-capital flows
- The debtor countries would be forced to deflate their economies
- Bank funding would dry up, seriously impairing domestic credit systems; exports would plummet, unemployment would soar

Six reasons why the Eurozone must not break up

1 If assets and liabilities suddenly have to be "rematched" following the re-introduction of national currencies, there would be an inevitable collapse in cross-border capital flows. Capital will thus become increasingly trapped within borders, leading to a sudden narrowing of current account surpluses and deficits.

2 The debtors dependent on inflows from elsewhere in the Eurozone would be forced to deflate their economies on a massive scale. Unable to receive credit from their neighbours, they would be much worse off. Lower levels of economic activity would lead to much lower tax revenues and, hence, larger budget deficits. With a severely reduced ability to fund those deficits internationally, either there would have to be austerity on a massive scale domestically or, instead, the central bank would need to turn on the printing press in a bid to create inflation and, hence, destroy the value of domestic savings, leading to currency collapse on the foreign exchanges. Bank funding would dry up, leaving domestic credit systems seriously impaired. Defaults to creditor nations would become regular occurrences.

3 The creditors would also fare badly. The holders of "peripheral" assets would be forced to nurse losses. Banking systems would be vulnerable. The inevitable reduction in current account surpluses – a reflection of lower cross-border capital flows – would be forced on the creditors via massive currency appreciation. The collapse in demand in their major trading partners would lead to plummeting exports. Unemployment would soar.

4 It would be wrong, however, to think about a euro break-up purely from the perspective of cross-border imbalances. To introduce new – and newly weak – currencies in the periphery, capital controls would almost certainly have to be utilised. Capital controls, however, would seriously undermine the functioning of the single market and would likely threaten the future of the European Union itself. Within the financial system, meanwhile, there would be a collapse in trust. Would debtors be able to repay creditors? What would they repay them with – newly issued creditor currencies, newly issued debtor currencies or legacy euros?

5 What would be the legal status of contracts taken out in euros if the euro itself was no longer legal tender? And, in the ensuing

mayhem, would any central bank be able to offer lender of last resort facilities to shore up Europe's now fractured monetary system? There would also be huge technical difficulties in abandoning the euro. Computer code would need to be rewritten. ATM machines would need to be reprogrammed. The required legislative changes could be lengthy, adding to the uncertainty.

6 Taken together, these challenges are reminiscent of the collapse of the US banking system during the Great Depression. It's not difficult to claim, then, that a break-up of the euro could threaten a Great Depression Mark II.

The solutions

- There needs to be a greater pooling of sovereignty over bond issuance and fiscal policy
- The EFSF needs to be beefed up
- The ECB's balance sheet must continue to provide the main firepower

Six ways to save the Eurozone

1 In broad terms the solution lies in a much greater pooling of sovereignty over bond issuance and fiscal policy. The European Financial Stability Facility (EFSF) – the main part of a European Union aid package to combat the sovereign debt crisis – is a move in the right direction but it only addresses the symptoms and, as it stands, is not big enough to cope with the Italian elephant in the room. For countries which cannot possibly get back to stability (Greece), default or restructuring is increasingly viewed as inevitable but can't be considered until a firewall has been erected around the European banking system and other peripheral government bond markets.

2 Even though national parliaments have now agreed to bolster the role of the EFSF, the total effective lending capacity of the revamped EFSF will still only be EUR440bn, which is insufficient to calm the markets. To put the numbers in context, the bond issuance of Italy and Spain in 2012 alone will be in the region of EUR230bn and EUR90bn, respectively.

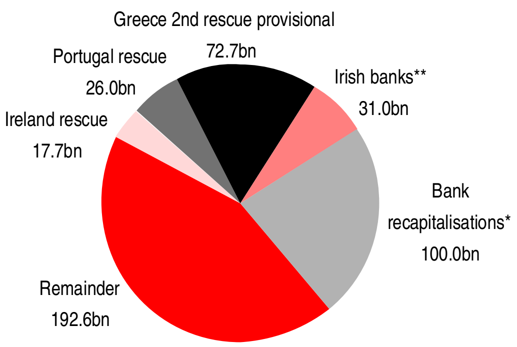
3 There are two ways the size of the support packages could be ramped up, either by using the balance sheet of the European Central Bank (ECB) directly or indirectly or using the balance sheets of the governments in the core. The ECB administers the monetary policy of the 17 Eurozone member states. These options could be undertaken via the EFSF or the new permanent mechanism, the European Stability Mechanism (ESM). Over the medium term the ESM would probably be the preferred solution as it would be using the balance sheets of the governments. The ESM, is scheduled to come into operation in July 2013, but the German Finance Minister has not ruled out bringing it forward by a year.

4 Alternatively, and most likely in the near term, the ECB's balance sheet must continue to provide the main firepower. It may be that rather than the ECB making the purchases, it repos the peripheral debt purchased under the EFSF, effectively allowing the EFSF to buy more. But this is smoke and mirrors. The amount of peripheral debt sitting on the ECB's balance sheet will continue to increase. But while recent discussions seem to be moving much more in this direction, we are still some way from any of these options being made concrete as it is unlikely they could be put in

place without another round of legislative changes by the 17 member states.

5 But saving the euro requires more than just firepower. At the heart of the issue is the clash between collective responsibility and national sovereignty. In particular, there needs to be a better way of managing the relationship between creditors and debtors. At the very least, there is a strong case for surveillance procedures to monitor not just the emergence of current account imbalances within the Eurozone but also the extent to which such imbalances lead to heightened claims by northern creditors on southern debtors. This is at least a step towards the first point, if not the second, in the new economic governance package being adopted by the EU.

Much of the EFSF's EUR440bn lending capacity has already been earmarked



Note: *IMF has suggested bank recapitalisation needs could be EUR200bn so we assume half will be provided by EFSF
**Irish government wants to convert the promissory notes it has given banks into EFSF funding
Source: IMF, European Commission and HSBC

6 We advocate the creation of a fiscal "club". Nations could become members of the club – an extension of the pooled sovereignty associated with the euro – or exile themselves to the outer fringes of the Eurozone: euro-ised but no longer fully paid-up members of the single currency. The fiscal club would have clearly-defined rules. In the event of a fiscal crisis that left countries short of funds in the market, they would be able to turn to their European partners. By doing so they would be required – temporarily – to sacrifice their fiscal sovereignty.

Country forecasts

	2010	2011f	2012f
Italy			
GDP	1.3	1.0	1.3
Budget balance (% GDP)	-4.6	-4.1	-3.2
Gross debt (% GDP)*	119.0	120.6	120.3
Spain			
GDP	-0.1	0.8	1.6
Budget balance (% GDP)	-9.2	-6.2	-5.1
Gross debt (% GDP)*	60.1	67.5	69.7
Portugal			
GDP	1.3	-2.2	-1.8
Budget balance (% GDP)	-9.1	-5.9	-4.5
Gross debt (% GDP)*	92.9	101.1	106.2
Greece			
GDP	-4.5	-3.8	0.6
Budget balance (% GDP)	-10.5	-7.6	-6.5
Gross debt (% GDP)*	142.7	156.7	161.3
Ireland			
GDP	-0.4	0.6	1.9
Budget balance (% GDP)	-32.0	-10.2	-8.6
Gross debt (%GDP)*	94.9	109.9	116.2
France			
GDP	1.4	2.1	1.9
Budget balance (% GDP)	-7.1	-5.7	-4.8
Gross debt (% GDP)*	82.3	85.2	87.2
Germany			
GDP	3.5	3.2	2.0
Budget balance (% GDP)	-3.3	-1.9	-1.1
Gross debt (%GDP)*	83.2	82.3	81.0

Note: *Gross debt (general government)
Sources: Italy: IMF Country Report No. 11/173 July 2011, Spain: IMF Country Report No.11/215 July 2011, Portugal: Economic Adjustment Programme 1st Review September 2011, Greece: Economic Adjustment Programme 4th Review July 2011, Ireland: Economic Adjustment Programme 3rd Review September 2011, France: IMF Country Report No.11/211 July 2011, Germany: IMF Country Report No. 11/168 July 2011

The European stabilisation facilities

	Facility	Size
EFSM	**European Financial Stabilisation Mechanism**	
	Available to EU countries conditional on economic and fiscal adjustment programme. Debt guaranteed by EU budget. First bond issuance was in January 2011 to raise funds for the loans to Ireland which are being provided by the IMF, EFSM, EFSF and bilateral loans from other EU states.	EUR60bn
EFSF	**European Financial Stability Facility**	
	Temporary mechanism. Available to Eurozone countries conditional on economic and fiscal adjustment programme. Debt guaranteed by cash buffer* plus 120% guarantee of each euro area country's pro rata share of issued bonds (ie over-collateralised). AAA-rated bonds. First bond issuance was in January 2011. Although the original EFSF had guarantees of EUR440bn, the effective lending capacity was only about EUR250bn due to the need to have cash buffers. The March 11 Eurozone summit agreed to raise the maximum lending capacity to the full EUR440bn. This was approved in June. On 21 July the EU Council agreed to enhance it further to extend loans of up to 30-year maturity at lower interest rates (100bps reduction for Greece and a 200bps reduction for Ireland and Portugal as they are currently charged higher rates than Greece). It will also be able to buy government debt in the secondary market to curb contagion and be able to buy the debt and make loans to non-programme countries to recapitalise banks. The hope is that all national parliaments will have passed the legislation by mid-October. This facility is currently being used to provide up to a third of the funding for the Irish and Portuguese assistance packages (EUR17.7bn and EUR26bn respectively) and the plan is that it will provide two-thirds of the EUR109bn second medium-term package for Greece. So while the remainder might just be enough to convince the markets that there would be sufficient funds if Spain needs a package, it falls well short of what would be needed for Italy.	Initial guarantees of EUR440bn but loanable funds were only about EUR250bn – so in June 2011 guarantees were raised to EUR780bn to increase loanable funds to EUR440bn
ESM	**European Stability Mechanism**	
	New permanent crisis resolution mechanism which will become effective in mid-2013 and will be based on, and replace, the EFSF. A rapid launch of the national approval procedures for the necessary Treaty changes should enter into force on 1 January 2013. As part of the mechanism, all new bonds issued in the Eurozone from 1 July 2013 will carry collective action clauses (CACs), which allow a specified majority of bond holders to overrule minority ones in negotiating a debt restructuring deal with the sovereign. Based on debt sustainability analysis by EC, the ECB and IMF, if a Eurozone country is judged to be solvent but experiencing temporary liquidity problems, it will encourage private investors to maintain their exposure to the sovereign and the ESM will provide liquidity support. If liquidity crisis turns into a solvency crisis each case would have to be negotiated separately with the creditors: no automatic solutions in terms of delays in interest payments or haircuts, etc and the ESM may provide liquidity support. The ESM will have a total subscribed capital of EUR700bn, of which EUR80bn will be in the form of paid-up capital provided in Eurozone member states. The rest will be committed callable capital and guarantees of Eurozone states.	Initially EUR500bn but it will be "subject to regular revision."

Note that the funds available via these facilities are in addition to the EUR110bn EU/IMF fund for Greece and the ECB's purchases of government debt.
*The net present value of the margin (cash reserve) and the service fee which the recipient country has to pay the EFSF are retained in a fund (invested in high quality liquid debt instruments) so these and any income earned on them are the cash buffer. Unlike the IMF, the EFSF is NOT a preferred creditor, nor will the ESM be.
Source: European Commission, Council of the European Union, EFSF, BIS.

The leverage options

The discussions at the September IMF/World Bank meetings generally focused on the fact that, even after the current revamp, the EFSF will have insufficient firepower to recapitalise banks and calm the markets in the event of any Greece-induced contagion. No official statements have been made but a number of different options have been mooted. We find it hard to see how any of the leverage options could be implemented without requiring more legislation from national parliaments as they would all involve new capital contributions and/or increased contingent liabilities that have not been included in national budget laws.

Facility	Proposal
EFSF	**Allow the EFSF to undertake repos**
	It could either use the bonds it purchases as collateral to borrow from the ECB (or fund itself in repo markets) in order to buy even more government bonds. This would require capital, which the EFSF does not currently have, and although the current revamp is to raise the effective lending capacity to EUR440bn and the pro rata guarantees are being passed in national legislation, any further increase in contingent liabilities would most likely require further legislation in at least some member states. The ECB's views appear mixed, with some members apparently more opposed to increasing the risk on the ECB balance sheet and blurring the lines between fiscal and monetary policy than others. There has also been press speculation (eg Reuters, 26 September) that the EIB could set up a special purpose vehicle (SPV) in connection with the EFSF to fund rescue packages but this has so far been denied by the EIB.
EFSF	**Credit protection**
	The EFSF would issue credit "enhancements" allowing the EFSF to offer the ECB or private investors credit protection for buying more sovereign bonds. Under this suggestion the EFSF would guarantee 20% of the first loss on debt issued by, for instance, Spain or Italy. The aim would be to lower/keep a ceiling on their bond yields in the event of any Greece-induced contagion. In this event the EFSF would probably have to raise capital.
ESM	**Bring forward the timing**
	The ESM is scheduled to come into operation in July 2013, but the German Finance Minister has not ruled out bringing it forward by one year. The necessary legislation for the original plan has not yet been passed, with Germany set to vote early next year. The ESM's capital is to be provided by the respective governments and the funds will be obtained through market issuance. As it would effectively be a bank it could potentially leverage up and be given a legal mandate to buy government debt. Over the medium term this would probably be the preferred solution as it would be using the balance sheets of the governments rather than leveraging the ECB balance sheet. It would be viewed as a more rapid move towards Eurozone bond issuance.

Source: Press reports, HSBC

Fixed income

- Eurobonds are needed for a Eurozone solution, says Steven Major, HSBC's global head of fixed income research

It has taken the threat of another Great Depression, but policy makers finally seem to be taking the initiative rather than mopping up in the wake of the market. Policy makers need to put together a long-term four-pillar "grand plan" to ensure that instability in the region's sovereign debt both goes away and stays away. The success of such a scheme would send flight-to-quality flows into reverse, driving up yields in the US, the UK and Germany. The four pillars in detail:

1 The Greek crisis must not be allowed to infect other Eurozone sovereigns and the banking system. To remove the uncertainty hanging over markets, private sector participation needs to be large enough to remove the worries of further restructuring and to do this the haircuts would need to be nearer to market prices. Reducing the stock of Greek debt by this amount would mean that fiscal sustainability would be possible, as long as access to liquidity is maintained.

2 Because of the Greek write-downs, there will need to be a recapitalisation of the banking system. This has been recognised already by the IMF, European Commission and large Eurozone governments, but it is not clear precisely how it will work. It could be that the EFSF is used to raise the necessary capital and/or there could be use of national facilities. Estimates from the IMF on the total size of recapitalisations centre on EUR200bn.

3 To finance the recapitalisation of banks and insolvent sovereigns, the EFSF will have to use a large proportion of its EUR440bn lending capacity. And at the same time this provides an opportunity to develop further common Eurozone issuance, or Eurobonds. The assumption that full fiscal union is needed first fails to recognise that common issuance from the EU, EFSF, EIB and others already exists. The challenge will be making progress using the institutions that currently exist within a relatively short space of time and to have the biggest possible impact. Proposals include expanding the role of the EFSF still further, to provide guarantees for single name issuers and capped liability issuance. The latter is a proposal whereby countries can issue Eurobonds up to a certain limit of debt/GDP and within pre-agreed constraints on budget deficits.

4 If the role of the EFSF is to provide support for the insolvent sovereigns and banks that need recapitalisation, then the ECB's firepower could be better directed at the solvent countries. ECB intervention in the government bond markets has been modest compared with that of the US Federal Reserve and the UK's Bank of England. Comparing the amount of bonds bought as a proportion of total gross issuance, the BoE bought 100% of gross supply in one year, while the Fed has taken 50% of the available supply onto its balance sheet over a two-year period. The ECB is still below 20%, even after the recent large-scale Italian and Spanish purchases.

What happens now?

- G20 meeting on 15 October ended on a constructive note
- Focus shifts to meeting of EU leaders on 23 October; markets remain sceptical
- A five-point plan is reported to be under consideration

G20 meeting urges action

The G20 meeting in Paris ended on 15 October with finance ministers and central bank governors urging the Eurozone to act decisively in dealing with the financial crisis, and holding out the prospect of international assistance conditional on swift and effective actions (sources: *Financial Times*, 16 October; *Bloomberg,* 17 October). Markets, however, remain sceptical of swift and decisive action, with yields on 10-year Greek government bonds broadly unchanged at 22% and most European sovereign credit default swaps (CDSs) only marginally tighter than on 14 October.

The five-point plan

All 17 members of the Eurozone have now voted in favour of expanding the size and role of the European Financial Stability Facility (EFSF). The next area of focus is a meeting of Eurozone leaders in Brussels on 23 October to discuss a comprehensive plan to address the range of issues faced by the Eurozone and its partners. G20 leaders will then meet in Cannes on 4-5 November.

Although the Eurozone finance ministers have not published their plan for tackling the sovereign debt crisis, based on reports from Bloomberg and the *Financial Times*, there are five main elements that are being considered – changes to the Private Sector Involvement (PSI) proposal of 21 July, back-stop facilities to support weaker banks, higher capital requirements for Eurozone banks, increasing the efficiency of the EFSF, accelerating the launch of the ESM and adjusting the decision-making mechanism within the Eurozone to facilitate faster response to crisis.

1. PSI alterations

The PSI proposal put forward by the Institute of International Finance (IIF) on 21 July 2011 included several options for holders of eligible Greek government bonds (GGB) that entailed a net present value loss of 21% for all options, based on a given set of assumptions (for details, please refer to HSBC's research note *Greek Debt Exchange Offer*, 30 August 2011).

On 15 October 2011, Germany's Finance Minister said in an interview that any reduction of Greece's debt through the private sector involvement must be bigger than the one agreed on 21 July. On the other hand, the IIF sought to push back on pressure on banks to accept larger losses on 10 October, when the IIF's deputy managing director, Hung Tran, was quoted on Bloomberg as saying that there were no plans to revisit the PSI and the risks and costs of revisiting the deal exceeded any potential benefits.

This view was echoed by Charles Dallara, IIF managing director, on 14 October 2011. Greek government bonds maturing after mid-2012 trade at cash prices of around 40-45, implying some scepticism regarding the proposals and highlighting that, should an orderly exchange of some sort fail, the alternative uncontrolled restructuring could result in low recovery rates.

2. Back-stop facility for banks

The statement from the G20 after last weekend's meeting also underlined the need to "preserve the stability of banking systems" (Bloomberg) and that banks needed to be adequately capitalised and have sufficient access to funding to deal with current risks.

According to the IMF's Global Financial Stability Report on 21 September, the Eurozone sovereign credit strain from high-spread countries is projected to have a direct impact of circa EUR200bn on banks in the EU. France's Finance Minister Francois Baroin said on 14 October (Bloomberg) that banks needed to increase their core capital ratio to 9%.

In terms of ways to achieve this, Christophe Frankel, the EFSF's Finance Director and Deputy Chief Executive, said recapitalisation should first be sought from the private sector, then from governments, before coming to the fund (*The Telegraph*, 14 October).

3. Increased EFSF efficiency

A boost of the rescue vehicle's effective EUR440bn lending power has been ruled out by Luxembourg's Prime Minister Jean-Claude Juncker (27 September, Bloomberg), while from the ECB's perspective, the increased bond purchases since early August were only temporary until the overhaul of the EFSF was approved.

The latter is evident in the declining amount of weekly Securities Market Programme (SMP) settlements from a peak of EUR22bn to around EUR2bn over the past two weeks. German Finance Minister Wolfgang Schaeuble commented on 15 October that Eurozone governments would agree on the necessary measures for effective use of the instruments of the financing facility so that the danger of contagion could be fought pre-emptively, but this would be without the ECB (Bloomberg).

However, one of the options that has been speculated in the press is the rescue vehicle fund providing bond insurance on debt issued by peripheral Eurozone states (WSJ, 11 October). With this option, the EFSF would be able to cover more than EUR3trn in bonds, but the assumption is that the ECB will continue its bond purchase programme.

4. Bringing forward the ESM

German Finance Minister Schaeuble has said that he would not oppose a plan to bring forward the ESM start date from the originally planned mid-2013. According to Bloomberg on 24 September, a faster ESM enactment would yield a "more effective financing structure" that would cut the extra debt of donor countries by EUR38.5bn, saving Germany alone EUR11.5bn.

This permanent mechanism will have a total subscribed capital of EUR700bn (of which EUR80bn paid-in and EUR620bn called) and a lending capacity of EUR500bn. Furthermore, ESM loans will have preferred credit status, while collective action clauses (CACs) will be included in the terms and conditions of all new Euro area government bonds starting in June 2013.

5. Increased economic management

The process of voting for the bail-outs and responding to the crisis in the Eurozone has so far been slow because of the need for unanimous parliamentary votes on a range of issues such as establishing the EFSF, expanding the EFSF, and the assistance provided to Greece, Portugal and Ireland.

In a fast-moving world, the Eurozone's decision-making mechanism appeared to have been behind the markets. In order to be able to respond more quickly and regain the initiative in resolving the crisis, a greater degree of unified economic management may be required.

As highlighted in the HSBC *Morning Message* of 17 October, according to Finance Minister Wolfgang Schaeuble, Germany may be willing to consider several steps towards a closer fiscal union, in line with the Stability and Growth Pact, in order to ensure government budgets do not get out of control and that there are penalties for any breaches.

Key events

Date		Date	
20 October	Spanish and French bond auctions	End October	Disbursement of 6th tranche (EUR8bn in total) of the EUR110bn bailout loan to Greece
21 October	EUR1.625bn of Greek T-bills mature		
22 October	EUR1.059bn of Greek bond interest payments due	1 November	Mario Draghi replaces Jean-Claude Trichet as president of the ECB
23 October	EU Council meeting, Eurozone summit		
24 October	Troika scheduled to issue report on Greece	3 November	ECB rate announcement
	EU and Chinese leaders meet in Tianjin, China	7 November	Meeting of Eurogroup finance ministers
25 October	Spanish T-bill auction	8 November	Ecofin meeting
27 October	Ireland presidential elections	3-4 November	G20 Cannes summit
28 October	Italian bond auction	20 November	Spanish general elections
29 October	Moody's three-month review of Spain due to conclude	29 November	Eurogroup meeting (tbc)
31 October	Belgian bond auction	30 November	Ecofin meeting (tbc)
End October	Greece scheduled to have voted into law the 2012 budget	8 December	ECB rate announcement
		9 December	EU Council (heads of state) meeting

Source: Thomson Reuters Datastream, Bloomberg, Dow Jones, European Commission, European Council, IMF and HSBC

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Appendix

Acronyms, key players and numbers

Acronyms and organisations

CACs, collective action clauses – allow a specified majority of bond holders to overrule minority ones in negotiating a debt restructuring deal with the sovereign.

EFSM, the European Financial Stabilisation Mechanism – Available to EU countries conditional on economic and fiscal adjustment programme. Debt guaranteed by EU budget. First bond issuance was in January 2011 to raise funds for the loans to Ireland, which are being provided by the IMF, EFSM, EFSF and bilateral loans from other EU states.

EFSF, the European Financial Stability Facility – A temporary mechanism available to Eurozone countries conditional on economic and fiscal adjustment programme. The EFSF's current role is to sell bonds to finance rescue loans. Its expanded powers would allow the fund to buy the debt of stressed euro-area nations, aid troubled banks in the region and offer credit lines to governments.

ESM, the European Stability Mechanism – New permanent crisis resolution mechanism which will become effective in mid-2013 and will be based on, and replace, the EFSF.

ECB, the European Central Bank – Administers the monetary policy of the 17 EU Eurozone member states.

European Union (EU) – An economic and political union of 27 independent member states founded to enhance political, economic and social co-operation.

Eurozone – An economic and monetary union (EMU) of 17 European Union (EU) member states that have adopted the euro as their common currency. The Eurozone currently consists of Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia and Spain.

Euro Group – An informal discussion forum for finance ministers from the Eurozone countries.

Ecofin, the Economic and Financial Affairs Council – Composed of the finance/economic ministers of the EU member states. It meets once a month to discuss issues including the coordination of economic policy, financial services, tax and the euro.

EU Council – Comprises the heads of state or government of the EU member states, along with the President of the European Commission and the President of the European Council. While it has no formal legislative power, its role is to define the EU's general political and strategic direction.

G20 – The Group of Twenty finance ministers and central bank governors was established in 1999 to bring together important industrialised and developing economies to discuss key issues in the global economy.

IMF – The International Monetary Fund is an organisation of 187 countries that works to foster international monetary cooperation, financial stability and sustainable economic growth around the world.

The Troika – Debt inspectors from the European Commission, European Central Bank and International Monetary Fund. Their report on Greece will help determine the next step to keep Greece in the 17-nation Eurozone.

Key players

Jose Manuel Barroso, European Commission President – he believes treaty changes to achieve even closer European integration will "probably" be necessary to cope with the crisis.

Mario Draghi, Governor of the Bank of Italy – replaces Jean-Claude Trichet as president of the ECB on 1 November 2011.

Timothy Geithner, US Treasury Secretary – says the crisis in Europe poses a "significant risk to global recovery." He has urged European leaders to go beyond a planned recapitalization of banks. "The most important problem is they have to make sure that the major economies of Europe that are under pressure now are able to borrow at affordable rates," he said in an interview with Bloomberg Television. "They recognise the need to do more than they've done so far."

Jean-Claude Juncker, Luxembourg Prime Minister and Eurogroup Chairman – says he expects international auditors to present their next report on Greek finances on October 24 and that he expects them to recommend paying the next tranche of aid.

Angela Merkel, German Chancellor, and Nicolas Sarkozy, French President – the leaders of the two strongest Eurozone economies who have promised a recapitalisation blueprint by the end of October that will supercede a 12-week-old rescue plan that has yet to be put into place.

George Papandreou, Greek Prime Minister – support for his ruling party sank to the lowest level this year after the government proposed a new property tax and cuts to pensions and wages, according to a public opinion poll.

Herman Van Rompuy, European Union President – pushed back a planned meeting of government leaders by a week to 23 October "to finalise our comprehensive strategy on the euro-area sovereign-debt crisis covering a number of interrelated issues."

Wolfgang Schaeuble, Germany's Finance Minister – has said that he would not oppose a plan to bring forward the ESM start date from the planned mid-2013.

Jean-Claude Trichet, outgoing President of the European Central Bank (ECB) – opposes suggestions that the ECB should lend to the EFSF to boost its capacity. The ECB says Europe's bailout fund should be increased by using government guarantees.

Evangelos Venizelos, Greek Finance Minister – said this month that the government will push through with commitments to international creditors to deepen pension and wage cuts.

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Key numbers

- Greece's gross debt load is forecast (by its Economic Adjustment Programme 4th Review July 2011) to climb to 161.3% of GDP in 2012, about double Germany's, as the economy contracts for a fifth year.
- Greece says it needs a EUR8bn aid instalment in November to avoid running out of money to pay salaries and pensions.
- EUR1.625bn of Greek T-bills mature on 21 October 2011.
- EUR1.059bn of Greek bond interest payments due on 22 October 2011.
- The total effective lending capacity of the revamped EFSF is EUR440bn. Many think this is not enough. To put this in context, the bond issuance of Italy and Spain in 2012 alone will be in the region of EUR230bn and EUR90bn, respectively.
- Banks in the region may need as much as EUR200bn (USD269bn) of additional capital, according to the International Monetary Fund's European head Antonio Borges.

Disclosure appendix

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