# TD Economics

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**European Union Summit: Positive steps, but not the end of the crisis yet**

European leaders held a two-day summit in Brussels to address the most pressing issues of the ongoing European debt crisis. Euro zone leaders agreed on the following items:

- The European Commission will present a proposal for a “single supervisory mechanism” – i.e., a common euro zone banking regulator – by December 2012. After this single supervisor is established, the European Stability Mechanism (ESM) will be able to recapitalize banks directly, with the involvement of the European Central Bank and appropriate conditionality. Conditions will include compliance with state aid rules, which should be institution specific, sector-specific or economy-wide and would be formalised in a Memorandum of Understanding.
- The Eurogroup will examine the situation of the Irish financial sector with the view of further improving the sustainability of the country’s fiscal adjustment program.
- Financial support to Spain for recapitalisation of its banking sector will be provided by the EFSF until the ESM becomes available. It will then be transferred to the latter, without gaining seniority status.
- They reaffirmed their commitment to ensure the financial stability of the euro area, in particular by using the existing EFSF/ESM instruments in a flexible and efficient manner. Use of these facilities to stabilise markets for Member States will have to respect their Country Specific Recommendations and their other commitments including respective timelines, under the European Semester, the Stability and Growth Pact and the Macroeconomic Imbalances Procedure. These conditions should be reflected in a Memorandum of Understanding.
- The ECB has agreed to serve as an agent to EFSF/ESM in conducting market operations in an effective and efficient manner.
- The Eurogroup has been tasked to implement these decisions by 9 July 2012.
- In addition to the euro zone leaders agreement, the European Union decided on a "Compact for Growth and Jobs". The main operational element of the Compact is the mobilization of €120 billion (equivalent to around 1% of EU gross national income) for measures that stimulate economic growth and recapitalize the European Investment Bank (EIB). The EIB's paid-in capital will be increased by €10 billion, which will increase its overall lending capacity by €60 billion, and thus unlock up to €180 billion of additional investment, spread across the whole European Union, including in the most vulnerable countries. This measure should enter into force no later than 31 December 2012.
- A second element of the Growth Compact includes the implementation of the Project Bond pilot phase. This will bring additional investments of up to €4.5 billion for pilot projects in key transport, energy and broadband infrastructure. Following a positive evaluation of the pilot phase, the volume of such financial instruments could be developed further in all countries in the future.
- At last, the President of the European Council, in cooperation with the Presidents of the Commission, Eurogroup and ECB have been tasked with presenting a specific and time-bound road map for the achievement of a genuine Economic and Monetary Union, which should be based on "four essential building blocks: an integrated financial framework, an integrated budgetary framework, an integrated economic policy framework and

strengthened democratic legitimacy and accountability". These were already put forward on their original report "Towards a Genuine Economic and Monetary Union", and an interim report will be presented in October 2012 and a final report before the end of the year.

**Key Implications**

- These announcements constitute a positive step forward towards crisis resolution in Europe. Breaking ground on a common banking supervisor project is perhaps the most significant step. However, we should keep our expectations well grounded, because these initiatives will not end the crisis.
- First, creating a single banking supervisor will prove a very difficult endeavor, because among other things, it will have to deal with the issue of bank resolutions, which has a fiscal component. Thus, it will inevitably raise the issue of ceding sovereignty, and therefore it will certainly require parliamentary approval in most countries.
- Second, the potential ESM direct capital injections into banks will still be subject to conditionality. Therefore, even if the intrusive IMF/EU/ECB "troika" missions can be avoided, countries accepting ESM loans will still be responsible for meeting their adjustment targets under the European Semester framework. This means that creditor countries will still have a say on domestic fiscal policies and structural reform programs. In other words, nobody is getting a free-pass, it is just a different surveillance process. The upcoming signature of Spain's Memorandum of Understanding will provide valuable insight as to how much flexibility will be provided under this new regime.
- Third, the benefits of more flexibility being granted to the EFSF/ESM will have to contest with the reality that funds will still have to be raised in the markets. Moreover, European leaders still have not found the gold pot at the end of the rainbow, and the size of the combined EFSF/ESM pool remains small when compared against the combined funding demands of hypothetical Italian and Spanish bailouts.
- At last, assuming these proposals go smoothly, the earliest the ESM will be able to directly recapitalize banks will be in the second quarter of 2013. That is still a long way off under current market conditions.
- To sum up, although positive, these announcements still carry significant implementation risks, and the markets are likely to test Italian and Spanish debt before these initiatives become operational. So it's probably good advice to keep your optimism on a short leash.

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