Northern Trust

DAILY ECONOMIC COMMENTARY

# European Union Summit – Important Questions Unanswered, IMF to the Rescue?

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Of the 27 nations that make up the European Union (EU), 23 agreed to be part of a new fiscal union, while the remaining four did not participate in the deal. Sweden, Hungary, and the Czech Republic want time to consult with their parliaments before signing to join the new union. Britain opted out because there were no guarantees that EU regulators would not be able over-rule financial regulators of the UK.

The summit ended with assertions pertaining to fiscal discipline. Members would have to run balanced budgets or maintain a surplus. This rule would be part of the legal structure of each nation. In the event of an economic recession, the budget deficit should not exceed 3.0% of GDP. Nations failing to meet this rule will be subject to sanctions. The public debt is not to exceed 60% of nominal GDP. These benchmarks were part of the original Growth and Stability Pact and are not new. The European Stability Mechanism (ESM) will be effective July 2012, while the European Financial Stability Facility will remain in place until mid-3013. The firepower of the EFSF/ESM is €500 billion, adequacy of this will be reassessed in March 2012.

The most interesting part of the summit's press release is the following:

> ***"Euro area and other Member States will consider, and confirm within 10 days, the provision of additional resources for the IMF of up to EUR 200 billion (USD 270 billion), in the form of bilateral loans, to ensure that the IMF has adequate resources to deal with the crisis. We are looking forward to parallel contributions from the international community."***

This part of the EU summit statement should be viewed in light of ECB President Draghi's remarks yesterday (which we noted in the December 8 edition of this comment). President Draghi disappointed markets when he noted that the ECB is a lender of last resort to only banks not governments. The actions of the ECB yesterday addressed liquidity issues of the bank by making available longer term loans, expanding collateral that is eligible for loans and reducing reserve requirements. He held on to the stand that the ECB will not violate its charter and purchase sovereign debt. President Draghi made the point that eurozone members could lend to the IMF and these funds could be used for general lending undertaken by the IMF to its members. He was suggesting a way to get around the legal provisions of the ECB that currently limit the powers of the ECB.

The IMF's Managing Director Chirstine Largarde's remarks today about the €200 billion contribution from the EU is closely linked with Draghi's comments and the EU summit press release. The following excerpt from the IMF statement drives home the point that the IMF will eventually be involved in a resolution of the eurozone crisis.

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***"The additional resources, she said, will enhance the IMF's capacity to fulfill its systemic responsibilities in support of its global membership--which is especially important given the ongoing economic slowdown and financial market tensions."***

The summit's communiqué indicates that questions regarding the sovereign debt crisis and inadequacy of capital in the banking system, as pointed out by the European Banking Authority on December 8 (€115 billion shortage of capital), remain unanswered. Sovereign debt is a significant part of the balance sheets of banks in Europe. Market stress is resulting from anxiety about the possibility of sovereign haircuts or defaults. The outcome of the summit is not reassuring because these related problems of sovereign debt and banking capital shortage have not been tackled. Moody's downgraded three banks today – BNP Paribas, Societe Generale and Credit Agricole.

At the end of the week, we have a "fiscal compact," which is a renewal and reinforcement of old rules and the IMF involved in the rescue plan. The role of the ECB in the weeks ahead is unclear. Draghi could change the game plan as the fiscal compact he alluded to last week has been in put in place. Is the ECB likely to be more dovish, now that fiscal austerity is supposedly taking shape? Wishful thinking?

## Drop in Oil Imports Leads to Lower Trade Deficit

The trade deficit narrowed to $43.5 billion in October from $44.2 billion in the prior month. A 0.8% drop in nominal exports of good and service and a 1.0% drop in imports of goods and services resulted in an overall improvement of the trade gap. Real exports of goods increased 1.2% but real imports of goods fell 0.3% in October. Oil imports declined in October (2.8%) reflecting a lower quantity and price. The improvement of the trade gap is a big plus for fourth quarter GDP if the November and December data fail to show a widening of the trade gap.

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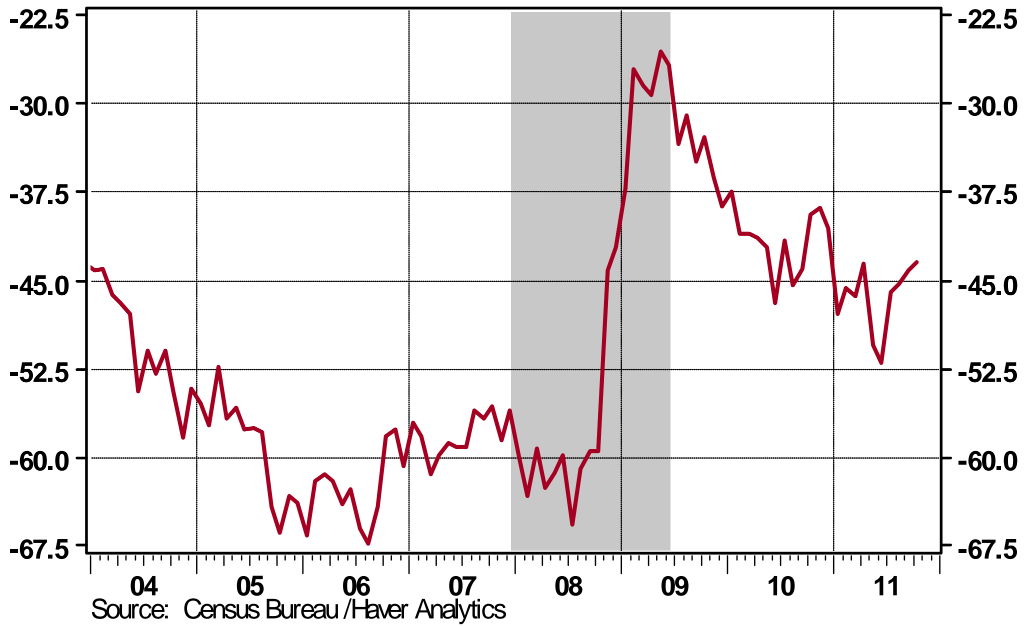
Chart 1




International Trade – October 2011

| | Trade Balance ($ billions) | | | Exports (m-o-m % change) | | Imports (m-o-m % change) | |
|---|---|---|---|---|---|---|---|
| | Goods & Services | Goods | Goods - 2000$ | Goods & Services | Goods - 2000$ | Goods & Services | Goods - 2000$ |
| Apr-11 | -43.6 | -58.1 | -43.5 | 1.3 | 1.0 | -0.2 | -3.2 |
| May-11 | -50.5 | -65.4 | -47.8 | -0.3 | -1.4 | 2.9 | 2.0 |
| Jun-11 | -52.1 | -67.1 | -50.3 | -2.2 | -3.4 | -1.1 | -0.6 |
| Jul-11 | -46.1 | -61.3 | -45.8 | 3.5 | 4.8 | 0.0 | 0.1 |
| Aug-11 | -45.3 | -61.0 | -46.3 | 0.1 | -0.7 | -0.2 | -0.1 |
| Sep-11 | -44.2 | -59.5 | -45.9 | 1.4 | 1.5 | 0.6 | 0.7 |
| Oct-11 | -43.5 | -58.8 | -44.2 | -0.8 | 1.2 | -1.0 | -0.3 |

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