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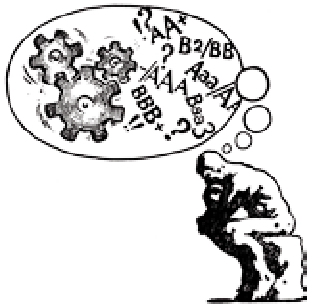

The best laid plans of Merkel and men...

The eurozone's political leaders don't seem to have much of a plan to deal with the crisis. Or if they do, they are keeping pretty quiet about it. Gary Jenkins wonders what they can throw together in the next few weeks.

It's always good to have a plan. They can be Cunning like Baldrick's or Incredible like Max Boyce's. They can become part of history like Marshall's or part of infamy like Stalin's. But it is good to have one.

So the market was buoyed early this week by the news that Angela Merkel and Nicolas Sarkozy had met in Berlin over the weekend and agreed that they will indeed have a plan by the end of October. It will encompass a comprehensive package to stabilise the eurozone, including a recapitalisation of its banks, if deemed necessary. All done and dusted then, European crisis over, move along please folks, nothing to see here.

It would be nice if that were the case. But, alas, they did not release any details of the plan, nor indeed were there any of the now traditional leaks — which leads me to believe that they actually haven't even got the germ of one yet.

If that is the case it really is an astonishing state of affairs. Maybe I am naive, but considering that as far back as 18 months ago the highest probability outcome of the European crisis was that Greece would have to incur a hefty default, you would have thought that all kinds of contingent plans would have been drawn up and tested in a dark room somewhere, that they would have a few battle plans drawn up ready to put into action depending upon the exact circumstances at the time. A paper file version of the "Break Glass In Case Of Emergency" kind of thing. But apparently not.

Instead, they are going to work it all out in the next few weeks.

From the various comments made by politicians over the last few days, I assume that the first EU draft plan will end up reading something like this:

"Right, first we have to accept that it's pointless only cutting Greek debt by 21% (not that it's really a 21% reduction for Greece but it sounded good at the time) as clearly that does not reflect the reality of their economic situation. So why don't we move closer to 65% which would bring their debt/GDP back closer to the Maastricht limit of 60%?

"Now in doing that we have to accept that the banks will be compromised because they will have to incur much larger losses than they thought just a few weeks ago when we agreed 'Greek bail-out II'.

What the eurozone needs is a plan so cunning, you could stick a tail on it and call it a weasel

"And of course much larger than we assumed at the time of the stress tests. So to make it up to them we will provide funds to recapitalise those banks where the capital ratios are starting to look a little bit low. These funds can come from the market, the relevant national government or the EFSF. We can sort out the detail later.

"We do acknowledge that there may be a couple of small problems with this idea. If the default — or 'private sector involvement', as we shall call it — is not voluntary, then it will trigger CDS contracts.

"Not sure what the impact of that might be. Don't think anyone is.

"And it is possible that investors think that whatever we do with Greece will be the template for any other European sovereign undertaking private sector involvement, and thus the bond prices of the 'challenged' sovereigns will get hammered. But not a lot we can do about that, then we will invoke Rule No. 1 — sweep difficult problem under carpet and waffle for as long as possible.

"So that's the banks all sorted, and hopefully our idea of talking about the financial sector as if the problem really lies there rather than with the sovereigns might just work, and the crisis will end there and then. But in the event that the market focuses its attention on the sovereigns again then we need to do something to shore those up too.

"Italy is probably the key here. Now at some stage the bloody ECB is going to stop buying Italian bonds, so we have to take responsibility for that under the EFSF.

> "Then we we will invoke Rule No. 1 — sweep difficult problem under carpet and waffle for as long as possible ... so that's the banks all sorted then"

"But if we have used €100bn of that for the banks, then after the €100bn already committed for Ireland/Portugal/Greece II, the remaining cash would only last 22 weeks if we buy Italian and Spanish debt at the same pace as the ECB has been doing.

"So we need to think of making the EFSF go further. We could use the EFSF to guarantee a portion of new bond issuance, thus encouraging investors to buy Italian debt because the EFSF would take, say, the first 20% loss. Just have to hope that they don't figure out that if Italy goes bust, it is likely that the loss will be a lot greater than 20%.

"But all we can really do is pray and invoke Rule No. 1 again.

"Right, considering what we have to work with, that should just about do it. Got holes all over it and the unintended consequences could bring the whole system down — but at least it's a plan. Can we get someone to type this up for Ange and Nic please?"

We will see what the real plan looks like in a few weeks' time. While the initial reaction to the idea of having a plan has been very positive, let us not forget the wise words of Robert Burns: "The best-laid plans of mice and men / Often go awry". ■