Deal or no deal?

"Merkozy" have saved the world – shades of Gordon Brown – and the initial reaction from the markets, this Thursday morning, is positive although the "good news" has been largely factored in with the FTSE rising from an early October low of 4868 to this morning's giddy 5700.

The Greek barber's bill has been agreed with the banks at 50% and as we suspected said "agreement" means this is not a default. Try telling your bank to bin half of your overdraft – see you in court! This was another one sided arm wrestling match. From Bloomberg this morning – Sarkozy said the bankers were escorted in "not to negotiate, but to inform them on decisions taken by the 17 and then they themselves went on to think and work on it." Luxembourg Prime Minister Jean-Claude Juncker said the banks' resistance was broken by a threat "to move toward a scenario of total insolvency of Greece, which would have cost states a lot of money and which would have ruined the banks." – ie get on board there's no bailout money.

Unsurprisingly the Greek debt held by the ECB is not subject to the haircut otherwise their capital base would have been wiped out and they would have needed a bailout themselves! Is this a prudent message to send to the banking community? After all they are never going to get this money back and will have to take the hit on the 50% at some stage if not the whole lot. "Loans" made by the IMF and the EFSF will be treated in the same way so the write off at this stage is not 50% but closer to 30%.

Now we come to the tricky bit of the cunning plan; gearing up the European Financial Stability Facility (EFSF). The remaining unused portion of the fund, circa €250 billion, will be used to "insure" the first 20% of any losses to purchasers of new euro debt issued, predominately one assumes, by Spain and Italy. This effectively gears up the fund to €1.25 trillion. This should cover issues by those two countries, where liquidity rather than solvency is the problem (hmm...) for the next eighteen months. But it still leaves around €1 trillion of existing PIGS debt uninsured and priced by a sceptical market.

It has already been announced that eurozone banks will need to raise €106 billion in new capital, by mid 2012, to meet the latest Basel requirements. Given the previous "miscalculations" on bank solvency in Europe, this figure looks way too low. Apparently the whole of the French bank sector only requires €8 billion to reach the 9% capital ratio target. Really?

The final part of the plan involves setting up a special purpose investment vehicle or SPIV to give it its more accurate title. Sovereign wealth funds, in particular the Chinese, will be invited to join the club, with the unspoken suggestion – a privilege not accorded to the banks – that failure to enrol could be costly.

All in all, the actual details of the plan are sketchy, so expect some more market moving headlines. As we enter the end of the year, the markets seasonally tend to rise, especially in the third year of a US presidential term, but there are more than a few potholes on the road to recovery, not least of all the possible loss of French triple AAA sovereign debt status; assuming any of the ratings agencies are feeling that brave. If you live anywhere near S&P's or Moody's offices in Paris do make sure your fire insurance is up to date...