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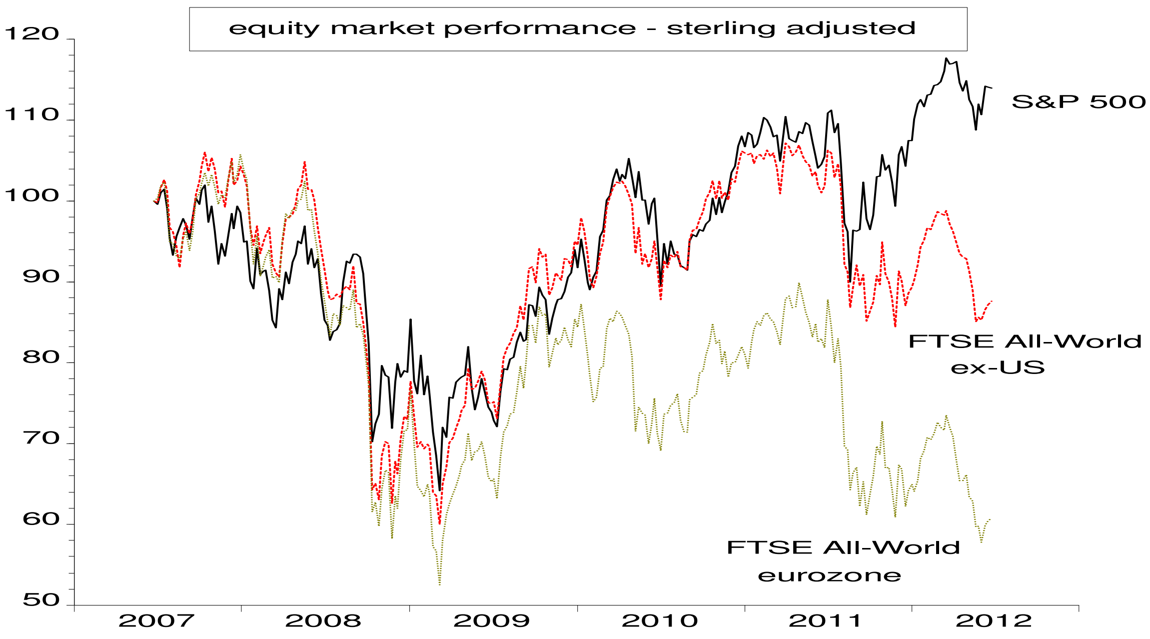
Eurozone leaders get the call to action – will they answer?



Source: DATASTREAM

Eurozone leaders must be feeling the heat like never before though not so much for the purpose of putting in place an immediate 'fix' to the crisis, but for presenting, finally, a unified front that demonstrates in no uncertain terms that where there's a will there's a way.

Prime Minister Mario Monti acknowledged as much at the end of last week when he indicated that leaders must deliver at this week's summit a '…clear medium and long term vision for greater integration'. He could not have been more straightforward in spelling out the risk of failing to do so: '… there would be progressively greater speculative attacks on individual countries, with harassment of the weaker countries.'

So a lot is riding on this week's European Union summit (June 28th and 29th) and to help get it off to the right kind of start, another pre-summit meeting is to be held this Wednesday in Paris. In contrast to last Friday's meeting involving Germany, France, Italy and Spain, Wednesday's pre-meeting is between Mrs Merkel and Mr Hollande and will likely aim to align their thinking on how to proceed towards the grand scheme of banking and fiscal integration.

For the markets then, this week's reasonably busy calendar of economic news, much of which focuses on the US, is likely to be superseded by prospective developments ahead of the summit as well as the outcome of the summit itself.

What will the markets be looking for?

In the first instance, steps required for a banking union involving bringing the banks under the supervision of a central body, this being the ECB, with a cross-border deposit guarantee facility and also the means for direct recapitalisation of troubled banks. The momentum behind all this has been picking up and while there is resistance from Mrs Merkel on the latter aspect, the tricky part is whether a banking union should apply throughout the EU, as the European Commission would like – and the UK would not – or only to members of the eurozone.

Also to be taken forward is the agreement by the leaders of Germany, France, Italy and Spain at last Friday's pre-meeting in Rome for a €130 billion package for growth, which will be something in the neighbourhood of 1 to 1.5 percent of eurozone GDP. Not huge in the context of the eurozone's stagnation, but better than nothing and maybe a start at what might possibly be something more along the way.

Mrs Merkel did not exactly warm last week to Mr Monti's idea of using the European Financial Stability Facility and/or its successor, the European Stability Mechanism to buy distressed sovereign debt in secondary markets, specifically that of countries complying with their reform objectives. The proposal did receive support from Mr Hollande, who believed it merited discussion at last Friday's get together in Rome. It is not clear what came of it, which suggests it was, and is, a non-starter.

Talking about non-starters, as part of last Friday's gathering too, debt mutualisation and eurobonds were a source of some consternation for the French President. This may well be part of the basis for Wednesday's meeting. For Mr Hollande, Mrs Merkel's reluctance to discuss debt mutualisation shows a lack of 'solidarity'. As he put it, '…there can be no transfer of sovereignty if there is not an improvement in solidarity.' That's telling her!

Well, telling it is. For Mrs Merkel the transfer of fiscal sovereignty to a supranational body must precede debt mutualisation and eurobonds. The triumvirate of 'pro-growthers' – France, Italy and Spain – will argue that even if this was to happen, it is not the answer to debt sustainability because without growth the latter cannot be achieved. There is room for negotiation, a quid pro quo, a concession to some of what the 'pro-growthers' want in exchange for a greater commitment to a fiscal union and that means accepting the transfer of fiscal sovereignty sooner rather than later. Cynics might say that, in holding out, Mrs Merkel has reached the point she has been aiming for all along.

But if the 'black cloud of uncertainty' is to lift, this is where the EU summit needs to go. On the face of it, Europe's leaders are approaching the summit with a greater sense of will and purpose than before. It's wise not to be too expectant. However, if the leaders deliver on the 'clear medium and long term vision for greater integration', equity markets might then be prepared to look beyond any the loss of earnings momentum – valuations are compelling even allowing for some of this – and recover the ground they have lost in recent months.