EUROGEDDON

THE FIRST TWO AND A HALF YEARS OF THE EURO CRISIS

REUTERS

BREAKINGVIEWS

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PREFACE

How did the euro zone get into such a mess? Can it get out of it?

Answering the first question is the easier of the two. The single currency was, at best, an extremely premature project. Many of the 17 countries which joined from 1999 onwards were not fit enough for the straitjacket of single monetary policy. Their labour markets were sclerotic, their welfare systems were bloated and they were often riddled with corruption.

These defects were not immediately apparent because the global economy was awash with liquidity in the early years of the new millennium. It was all too easy to rack up debts. Banks were poorly regulated. Governments also broke rules designed to limit their borrowings. In large parts of the euro zone -- especially Greece, Ireland, Portugal, Spain and Italy – people were able to live beyond their means. The imbalances of excessive debt, housing booms and uncompetitive economies got ever bigger – until the bubble popped.

Can the zone solve its troubles? The evidence from the two and a half years since Greece revealed it had been cooking its books is not encouraging. So far five governments have had to ask for bailouts. Banks have both infected their governments and been infected by them. Large parts of Europe have been sucked into a deep recession.

Meanwhile, the politicians have been unable to stop the damage, despite a seemingly endless succession of summits. The explanation is not difficult to find. The peripheral euro countries are suffering from problems that have built up for years if not decades. The only long-term solution is deep structural reform, which is unpopular and won't deliver its benefits overnight.

Politicians in peripheral southern countries have tried to deny the extent of the problems. When they couldn't do this any longer, they tried to get the core northern countries led by Germany to bail them out. But the northerners have been reluctant to do this – partly because they don't want to part with their money and partly because they think the southerners won't reform if life is made too easy for them.

While the standoff is understandable, the consequence is that faith in the single currency is evaporating and even northern countries are being sucked into a recession. If the euro collapses, everybody will suffer.

Eurogeddon, a compilation of stories written as the crisis unfolded, charts the twists and turns of this unhappy tale. The final chapter sketches out a way forward.

Hugo Dixon
Editor, Reuters Breakingviews
July 2012

CHAPTER 1
CRISIS IS A GREEK WORD

The Greek crisis first burst into the public consciousness in October 2009 when George Papandreou's new government announced that its predecessor had been cooking the books. The next month, he revealed that the 2009 budget deficit would be 12.7 percent of GDP rather than 6 percent and passed an austerity budget designed to bring it back under control. The people were not happy: there was a general strike in February and a mass protest with petrol bombs in March.

Markets weren't happy either. Greek 10-year bond yields shot up from 5 percent in November 2009 to 8 percent by April 2010. Investors weren't just worried about Athens' excessive debt load. They were also concerned about how uncompetitive the economy had become during the fat years after it joined the euro. Wages had shot up much faster than productivity. The result was that the country had a massive current account deficit as well as its budget deficit. Economists began to question whether it wouldn't be better for it to quit the single currency.

Initially, Papandreou denied that Greece needed help. But by May, he had asked for a 110 billion euro bailout – with 30 billion provided by the International Monetary Fund. The essential deal was Greece got loans in return for further budget cuts and reforms. It also had to agree to regular monitoring by the troika: the European Commission, the European Central Bank and the IMF.

But its international rescuers did not want Athens' debt restructured. They were afraid this would trigger contagion in other weak countries, especially Ireland and Portugal. In order to prevent that, they also created the European Financial Stability Fund, a 440 billion euro bailout fund. They hoped that the mere fact of having such a big bazooka would scare traders from betting against other countries' bonds and so the fund would never have to be used.

The ECB also rode to the rescue buying Greek, Irish and Portuguese bonds in the market. Although this didn't break the letter of the Maastricht Treaty – which prevents the central bank from funding governments -- it came close to breaking the spirit and sparked huge controversy.

STRONG CURRENCY, WEAK COUNTRIES
BY IAN CAMPBELL

The eurozone is facing the first major economic downturn in its short life. How the experimental system fares is highly uncertain.

The euro boy, just ten years old, enters the global recession looking manly. It is, at a value of about $1.32, worth more than the $1.17 at which it launched, and much more than the sub-90 US cent lows of 2000-2 to which the then-rampant US dollar bullied it in its infancy.

The euro is admired. Slovakia has just joined the zone. Other countries speak of joining soon, to benefit from the euro's strength.

But a currency's value and prestige are not always the best guide to underlying economic strength and durability. Sterling was recently worth more than $2. The UK economy and the pound were about to plunge. The Argentine peso had been worth one US dollar for a decade when Argentina defaulted and devalued, abandoning the experiment.

French President Sarkozy and German Chancellor Merkel shake hands after news conference in Berlin. 09 Jan 2012
Reuters|Fabrizio Bensch

Argentina's currency board system, with its fixed exchange rate and foreign reserve backing for the monetary base, was in theory robust. But it proved brittle. Forming a

REUTERS

rigid link between a small, indebted, historically ill-managed and frail economy and the world's reserve currency did not, in the end, make Argentina strong.

The question with the euro system is whether the same may be true: that the strength of the euro, as an important currency seen by some to rival the dollar as the world's reserve currency, masks the frailty of some of the zone's member economies – until a crisis makes that frailty all too apparent.

By adopting the euro, the member countries surrendered exchange-rate flexibility and their ability to set interest rates independently of one another. What they gained was undoubtedly immense, especially for the smaller economies. Easier trade and travel was just the most obvious benefit. The financial gains were enormous. The capital market in Irish pounds or Spanish pesetas had been relatively small and the cost of issuing debt high because the currency, inflation and fiscal risks for investors were also high. The euro seemed to eliminate all those risks as if by magic.

There would be no devaluation-provoked surge in inflation. The European Central Bank, sitting in Frankfurt, would be hawkish. The stability and growth pact would ensure fiscal discipline. Governments' finances would be sound and there would be nothing to cause excessive inflation. Investors in eurozone members' debt would face little risk.

Until recently, the market seemed to believe all this, even though many countries breached the 3percent of GDP limit for their budget deficit and the 60percent of GDP limit on public debt. The difference in the spread between Irish, Greek, Italian or Spanish debt and German debt was small.

But since the credit crunch struck and the euphoric period for the global economy ended, the spread differentials have begun to widen fast. The markets' euro assumptions are beginning to be challenged.

Part of the problem is what eurozone membership obliges and takes away. It obliges governments not to abuse their new-found freedom to issue debt cheaply by issuing too much of it. It obliges countries to achieve long-term competitiveness without resort to devaluation. It forces adjustment to changing economic circumstances without independent, national monetary policy and exchange rate flexibility. And even the fiscal lever cannot be moved too far if the guideline of a maximum 3percent of GDP fiscal deficit is to be observed.

In the recent happy years for the global economy, however, some eurozone countries appear to have given as little thought as the markets to the constraints imposed by eurozone membership.

In Spain, for example, labour costs have soared. That caused no immediate problem. A construction boom kept the economy growing fast. But now the boom has ended, Spain is left with an expensive labour force and no means of regaining competitiveness easily. Unemployment has already risen by almost 1m workers in the past year, to about 13percent of the workforce.

Spain, unlike the UK, cannot help its industries compete at home and overseas through devaluation against its main trade partners. On the contrary, the euro is strong. That implies economic adjustment must come arduously - through recession, redundancies, and renegotiated wage agreements that force wages down. Politically and socially as well as economically, the process will be difficult.

In Ireland, other vulnerabilities created by the euro's initial free lunch are now exposed. The euro slashed the interest rate on credit and mortgages, provoking a boom in house prices, growth and government revenues. Now the government's deficit is heading towards 10 percent of GDP. Ireland's previously low debt of a quarter of GDP could double in a few years. Iceland has been helped by the International Monetary Fund and is drawn to the euro. Ireland has the euro and might need the IMF.

Italy's debt exceeds its GDP. Fractious politics have put fiscal or labour reform on hold. Labour costs have risen fast. Italy has not even dared think of putting funds into fiscal stimulus. Now in recession, and having grown by barely 1 percent annually in the recent good years for the global economy, the country risks chronic weak growth.

It was precisely this combination of unremitting high debt, lack of competitiveness and recession that brought Argentina's currency experiment to an end. When Argentina faced trouble it could not devalue. Nor could the government print money, as it had done so often in the past with disastrous inflationary consequences. Adopting a strong currency meant Argentina had no way out – other than via a default on debt and abandonment of its currency experiment.

As eurozone governments face recession, soaring demands on the fiscal purse and rising debts, there is a risk that some countries will find the shared, strong currency more a crushing constraint than a strength.

The eurozone experiment is entering a new, potentially explosive phase. The admired euro boy may be about to suffer a painful adolescence.

Published 16 January 2009

BEWARE OF GREEKS BEARING DEFICIT ESTIMATES

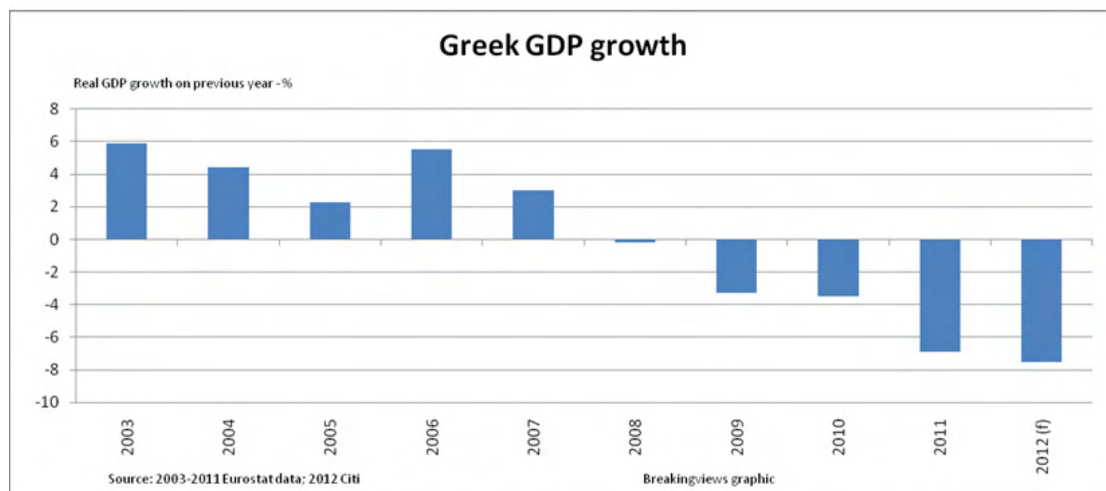
BY CONSTANTINE COURCOULAS

The EU is about to throw a fit over the state of public finances in Greece. It will scold Greece for running a budget deficit that is expected to hit 12.7 percent of GDP in 2009, more than double previous estimates. It turns out the government has been severely misrepresenting the true state of its affairs.

The European authorities are angry. European Central Bank President Jean-Claude Trichet has publicly criticised Greece for producing unreliable statistics. And the European Commission is expected to officially single out the county as the group s weakest link on Wednesday. It could threaten Greece with financial sanctions if it fails to

reform.

The ratings agencies are also concerned. Fitch has cut the country s sovereign debt rating to A- and Moody s has placed Greece on review for a possible downgrade.



But the markets have taken the revised deficit numbers in stride. The yield on Greek government bonds had fallen by 180 basis points since the end of January. The new numbers only reversed 20 bps of that. In effect, the abundant supply of cheap money means that reckless Greeks end up paying only 140 bps more on their debt than the relatively prudent Germans.

This isn't the first time Greek politicians have got away with stretching the fiscal truth. Back in 2001, Greece understated its budget deficit in order to qualify for eurozone membership.

While sanctions are possible this time, the politicians in Athens don t need to lose much sleep. The only penalty that would really matter expulsion from the eurozone is totally unthinkable, at least for the foreseeable future.

But complacency is dangerous. If Greece does not change its fiscal ways toward more integrity and smaller deficits the unthinkable will turn into the inevitable.

The recently elected Pasok government should use the mounting pressure from Europe as a justification for doing the right thing: embarking on the daunting and politically unpopular project of clearing up the government s finances. If it waits for the markets to care, it could be too late.

Published 10 November 2009

ON THE CHEAP
BY PIERRE BRIANÇON

At least it's a deal. And it may give Greece some breathing space. But besides that, everything is wrong with the compromise agreement on alleviating Greece's financial problems. The accord on Thursday showed that euro zone leaders were unable to deal with their first major crisis since the single currency's inception 11 years ago. And there is no reason to believe they have learnt enough from the crisis to avoid a repeat of this self-made fiasco.

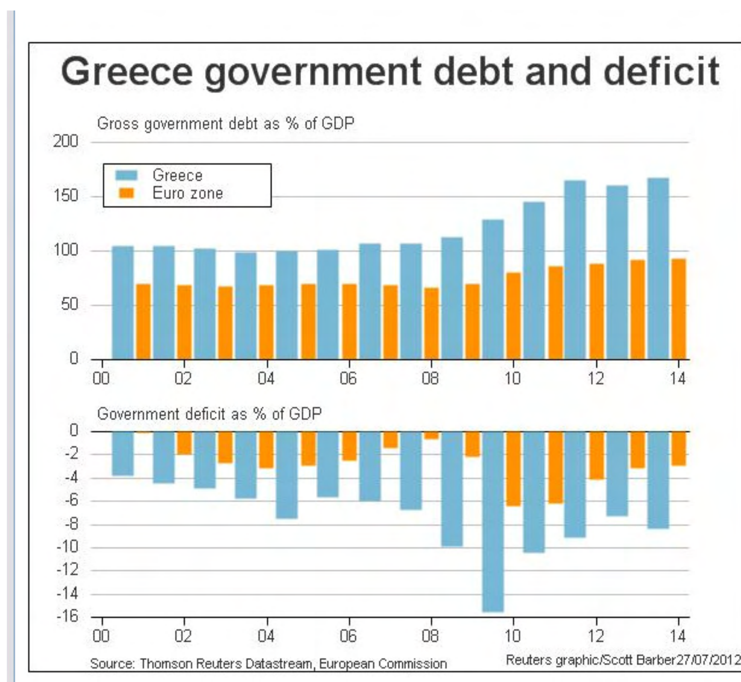
Angela Merkel, the German chancellor, was up in arms against any form of bailout and succeeded in putting in the euro leaders' statement some tough-teacher words. She can take these back home to prove to her voters that she didn't lavish money on those irresponsible Greeks.

So EU bilateral loans will only be granted as a last resort - whatever that means for a country which already has to pay twice as much to finance itself as Germany. Furthermore, any decision will have to be unanimous, which means Germany will keep a veto right. The dirty little not-quite-secret is that everyone hopes no decision will be required before May 9, when Merkel faces a crucial regional election.

The IMF role will mostly be to provide cheap money. It can't ask Greece to devalue and won't insist on toughening the country's already serious deficit reduction plan. From the Greek point of view, this may be the only good news in the deal: if a third of the money ultimately comes from the IMF - as indicated by French president Nicolas Sarkozy - some 8-10 billion euros ($11-13 billion) could be borrowed at an interest rate of about 2.8 percent, compared to the current yield of more than 6 percent.

But the Greek deal sends a terrible message to other euro countries that might run into financing problems: go directly to the IMF, do not pass by the euro zone, do not collect money there. Not only will you get cheap money, but you will also let the Fund devise and implement your deficit-reduction plan, thus giving you the option of blaming the bad cop.

Published 26 March 2010



A RESCUE TO ALARM THE ZONE

BY IAN CAMPBELL

The European Union has acted to prevent a Greek Lehman. The taxpayers of the euro zone and IMF member countries are going to cover Greek debt payments for more than two years. Greece is set for punishing austerity. The country's salvation comes at a staggeringly high price of 110 billion euros, yet still looks temporary, with the debt burden remaining far too large. Worries will persist - for Greece itself and for the euro zone.

The EU has shown it is ready to spend heavily to prevent the fall of one of its own. But its resolve also reflects a no doubt accurate calculation. Without support Greece would have defaulted imminently. Like Lehman Brothers in 2008, it would have collapsed, bringing big losses to bond holders. Serves them right, some might say - including many German politicians. But the agony in Greece itself and the contagion into other vulnerable euro zone economies would have had to be reckoned with.

Greece faces harsh austerity now - cuts in government spending and increases in taxes coming to 11 percent of GDP over four years. But the pain of default would have been far worse. There would have been no capital inflows to fund fiscal spending. The wage and pension cuts for Greece's public sector workers would have been even sharper. The Greek government, broke and besieged by voters demanding money and unable to supply euros, might well have left the euro zone and printed drachmas.

In the markets, a Greek Lehman would have sown panic. Ireland, Spain, Portugal and probably Italy would have come under intense pressure, with bond yields soaring. The market would have looked desperately for proof that all the vulnerable euro economies were not going to follow Greece. The EU would have had to provide assurances of support while insisting on drastic fiscal cutbacks. Just like Lehman I, the sovereign sequel - Lehman goes Greek - would have been very expensive and complicated. It was, understandably, a film the EU was not keen to direct.

And so instead it has run out a big bailout. The 110 billion euro sum, including a 30 billion euro contribution from the IMF, aims to nurture Greek recovery over three years. It is a little less than rumoured in recent days and yet staggeringly large: one third of Greece's GDP. All this for an economy which was deemed safe only months ago by most economists. Now worries will persist, about Greece itself and about other zone economies with big deficits and debts.

For Greece the political and economic difficulty of shifting from euro party to euro austerity is enormous. The EU and IMF deal rightly addresses the wage and pension abuses in the Greek public sector. The savings that can be made are no doubt great. And yet by 2013, when Greece is expected to begin tapping financial markets again, it is projected still to be running a fiscal deficit of 4.9 percent of GDP and carrying a horrific debt to GDP burden of 149 percent. Whether markets will be ready to lend is highly questionable.

Nor would that be the sum of Greece's remaining problems. Normally a sovereign crisis provokes a devaluation which helps cut real wages and rebuild competitiveness and a default that alleviates the debt burden. But only if Greek private sector wages tumble will the competitiveness lost during the first decade of the euro be regained. Greece's medium-term ability to grow and to service its debt as a euro zone economy is still far from assured.

The EU and IMF may begin to lean towards debt restructuring. Greeks themselves may begin to wonder if life is better outside the zone.

For now, though, the EU is unlikely to focus on further stages in the Greek rescue. It may instead leave the IMF to administer rapid austerity while it turns to other economies with similar weaknesses. In Portugal, Ireland and Spain the debt burden is rising fast. The size of the Italian economy and the scale of its debt, 115.8 percent of GDP in 2009, a fraction worse than Greece, make it ultimately the greatest risk of all.

Socialist leader Papandreou addresses lawmakers prior to a vote for a new austerity deal in Athens.
12/02/2012
Reuters | John Kolesidis

The danger is that markets, seeing how quickly Greece has unravelled, begin to push up the cost of financing for the euro periphery. The only way to stop that is to get on much more rapidly with fiscal cuts. The markets' fear and greater EU firmness may help to make that happen.

The Greek rescue therefore offers brief calm yet ought to be an alarm. Unless other indebted economies in the euro periphery stop their debt spiralling they too are likely to head towards crisis. And in Greece itself crisis may be far from over.

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MASSIVE ATTACK
BY PIERRE BRIANÇON

The euro zone has gone for the big numbers - and it works, at least for now. European Union leaders and their finance ministers have come up with a 720 billion plan to stop contagion in sovereign debt. The European Central Bank has agreed to play ball, and will add sovereign bond-buying to its crisis-fighting tool box. The central bank is also

spraying liquidity at the banks to stop the sovereign crisis turning into a new banking one.

To address concerns that their actions play with moral-hazard fire, EU leaders have made any aid to troubled economies conditional on fiscal and structural reforms. The International Monetary Fund will play a major role in any rescue, sending a strong signal that bailout money will only be dispensed with bitter medicine. And the ECB has made clear that it has only agreed to bond-buying because member countries have pledged to meet their fiscal targets. This is a serious and welcome plan. But it's only the opening act of what will be a difficult adjustment period.

A protester sprays riot police with a fire extinguisher during violent anti-austerity protests in Athens' Syntagma square. 12/02/2012
Reuters | Yannis Behrakis

In the short run, there has been a dramatic relief rally. The euro has rebounded, as have stock markets. The pressure has also been taken off both weak countries and banks. Spreads on ten-year Portuguese bonds, for example, fell by more than a third. And there was a major easing on the interbank market, with bank credit default swaps falling sharply and bank shares rising up to 20 percent.

The hope is that Portugal and Spain - which were uncharacteristically singled out in the finance ministers' communique - will have a breathing space to sort out their fiscal problems without having to access the new bailout funds. They need to come up with

serious deficit-reduction measures by May 18. That will be the first test. Spain's early offer - cutting its deficit by an extra 0.5 percent of GDP this year, and 1 percent next year - looks timid so far.

But even if Portugal and Spain - as well as other fiscally-challenged southern countries - come up with credible plans to restore budget discipline, that won't be enough to secure the euro zone's long-term stability. France and Germany, which all but killed euro zone discipline six years ago by refusing to accept it for themselves, will have to show they are willing to abide by the same framework as their southern brethren. And implement the same type of structural reforms - including the public sector and pension systems - that they are demanding from others.

Published 10 May 2010

STRUCTURED FINANCE TO THE RESCUE

BY NEIL UNMACK

The European Union's new 440 billion euro rescue package draws on the techniques that fuelled the structured finance boom. It will make loans to struggling borrowers, packaged in a special purpose vehicle that will be rated AAA. Investors should make sure they approach this SPV with more caution than they gave its toxic predecessors.

Euro zone politicians won't welcome the comparison with collateralised debt obligations, which fuelled the credit boom and helped cause the crisis. The euro zone's SPV has a more benign purpose. It will issue bonds, guaranteed by member states, and use them to make loans to struggling countries. Each country will contribute guarantees in proportion to its shareholding of the European Central Bank.

But the euro zone's SPV relies on similar techniques to those pioneered by CDOs to make poor-quality assets appealing to bond investors. The first is diversification. By spreading
the risk of sovereign default among the euro zone's 16 member states, the European Financial Stability Facility (EFSF) should be able to borrow at a cheaper rate than the weaker countries could on their own.

However, this alone won't be enough to guarantee the AAA rating that the SPV needs to ensure low rates. The risk is that weaker countries might not be able to make good on their guarantees, undermining the whole structure.

That is why lawmakers have agreed that each country will guarantee a fifth more than its share. So 440 billion euros of debt will be backed by guarantees worth 528 billion euros. This will create a buffer in case one country falls by the wayside. In securitisation jargon, the SPV will be over-collateralized. There's nothing inherently wrong with the securitisation techniques the EFSF will be using. Nevertheless, as they learned with the CDO market, prospective investors should take note of potential problems.

One risk is that even solvent countries refuse to honour their commitments. The guarantees will take force once euro zone members' parliaments have approved the bailout. But governments can change, and there is always the risk of court challenges from bailout objectors.

Second, the quality of the SPV's bonds is only as good as the combined creditworthiness of its guarantors. A further downgrade of Greece, which makes up about 2.8 percent of the ECB's capital, would have little effect. But if France were to lose its AAA credit rating, it would be harder for the SPV to maintain its own rating.

The SPV will probably have to pay a premium to other AAA-rated debt to compensate for these risks. If investors have learned the lessons of the CDO boom, they should make sure they are getting a good deal.

Published 8 June 2010

CHAPTER 2
DUBLIN DOMINO

The big bazooka didn't work for long. Greece's debts hadn't gone away. Quite the opposite, they kept rising. Although the Papandreou government initially made good progress cutting spending, it found it hard to raise taxes.

The markets also started focussing on how banks in Greece, and elsewhere, were up to their eyeballs in sovereign debt. As their balance sheets were shot to bits, they lacked the confidence to lend. The infection of banks by its government was the first part of what later came to be known as the sovereign-bank doom loop.

The second part of the loop – where weak banks infect their governments – was displayed in Ireland, to which investors now turned their attention. It had suffered a massive credit-fuelled property boom. The government had foolishly decided to guarantee its banks' debts just after Lehman Brothers went bust in 2008. When it had to bail out its lenders, the government's own debt mushroomed.

The European authorities tried to restore confidence in the entire region's banking system by conducting a stress test in July. But when this concluded that there was a capital shortfall of only 3.5 billion euros, it was widely ridiculed.

The Irish government wanted to haircut the senior debt of the banks it was rescuing, on the grounds that this would reduce the amount of money it would have to find. But the ECB was adamant that senior bondholders should not face any write-downs – fearing that this would cause contagion elsewhere.

Dublin's yields shot up from 5 percent in May to 9 percent in November. Things were not helped when Germany's Angela Merkel and France's Nicolas Sarkozy – a couple that came to be known as "Merkozy" – met in Deauville in October and agreed that private sector investors would at some point in the future have to shoulder some of the burden of bailing countries out.

The Irish government initially denied that it needed help. It knew it would have to impose a politically unpopular austerity programme. But by November it had to ask for an 85 billion euro bailout. A few months later, Brian Cowen's coalition government had fallen.

AFTER THE GOLDEN AGE
BY IAN CAMPBELL

Until 2006 Ireland enjoyed a carefree euro zone youth. As if by magic, low euro interest rates turned houses from bricks to gold and the enriched Irish spent freely. Now the houses are dull brick again, banks have had to be rescued and debt deflation stalks the land. No wonder Moody's downgraded Irish government debt on Monday.

Ireland has been praised for addressing its banking crisis, but it had to. The banks, like Ireland as a whole, had bought into the property bubble. Without huge government intervention the financial system faced systemic collapse. Now the costs of the bubble are all being harvested.

House prices are down by almost a half from their peak in Dublin and still falling, as part of generalised deflation in the Irish economy. The annual inflation rate was the lowest in the euro zone in June, at minus 2 percent. And the fiscal deficit this year will be by far the worst in the EU, at close to 19 percent of GDP, driven up by the costs of rescuing banks.

This year the government is transferring almost 13 billion euros, about 8 percent of GDP, into two banks, Anglo Irish and Irish Nationwide. The injection into Anglo Irish is part of 22 billion euros in transfers to prevent the bank imploding.

A pedestrian walks past graffiti depicting Irish Finance minister Brian Lenihan and Prime Minister Brian Cowen in South Dublin. 28/11/2010
Reuters|Cathal McNaughton

Depositors in these institutions will come out whole, but ultimately only because Irish taxpayers will provide. They will also eventually pay for the National Asset Management

Authority, the government's newly-created bad bank. NAMA has received 15 billion euros in problem loans, with another 13 billion euros to follow this month - and more thereafter. It recently revealed that only a quarter of the first tranche of loans are performing - not the 40 percent that the banks themselves had earlier said.

It is the banking sector's woes that are pushing this year's fiscal deficit up to 19 percent of GDP. But excluding those costs the deficit would still be in double digits as a share of GDP - and is currently expected to remain at that unacceptable level in 2011. The government needs to address that.

It has not so far faced financing problems. The bulk of this year's financing requirement has already been raised. But public debt is soaring - from only a quarter of GDP before the crisis to a troublingly high 93 percent of GDP by 2011, according to local forecaster ESRI.

The danger is clear. An extremely high level of public debt may make financing a continuing problem in years to come, while interest payments weigh heavily on the public purse. The government has already cut spending and public salaries and has been praised. But the reality is that it must do much more to get the deficit down.

It helps that growth has revived. In the first quarter Ireland had the EU's fastest growth rate, up by 2.7 percent on the fourth quarter of 2009. The almost 7 percent volume rise in exports in the first quarter reflects the recovery in world trade and Ireland 's encouraging ability to participate, despite the apparent burden of a strong euro - and a weak British pound. Earnings from the pharmaceutical sector defied the global downturn and went up last year. Export-led recovery looks possible.

And collapsing domestic spending has its good side. The trade deficit is gone. Unlike Spain, Italy, Greece and Portugal, Ireland does not have the classic twin deficit problem. The Irish are saving and those savings can help finance government borrowing. But depressed wages and high unemployment - the rate has soared in two years from 5 to 13 percent - are bad news. Businesses and house prices must cope with that, and so must banks and tax revenues. Money once rained down, now it must be squeezed out with further austerity - and without driving away the companies that are providing export-led growth.

Ireland is starting to look like a mature euro zone economy: prosperous but with too much consumer debt and unemployment, a probable modest growth rate and an enormous deficit that must be tackled.

How much fun euro youth was. How heavy the burdens of euro maturity.

Published 19 July 2010

STRESS FRACTURE

BY PETER THAL LARSEN

Europe's bank tests were not stressful enough. Only seven of the 91 lenders participating in the exercise administered by the continent's regulators will need extra capital to see them through a severe economic shock. The exams were undermined by failing to imagine a sovereign default. Forcing banks to disclose their government bond portfolios, however, gives investors the power to conduct their own more rigorous assessments.

The official tests fell short in two important ways. First, regulators used Tier 1 capital to assess balance sheet strength, clearing any bank that had a ratio of more than 6 percent after a two-year economic shock. But Tier 1 capital, which includes hybrid debt and other non-equity instruments, has been widely discredited. Investors no longer trust it, while regulators are trying to agree a tougher definition of capital.

The second, and bigger, failing was the way the tests handled sovereign debt. Despite concerns about the finances of Greece, Spain and other euro zone countries, banks were not forced to withstand a hypothetical default. The compromise regulators devised was to assume a sharp widening of government bond spreads.

This test, however, only affected portfolios that are marked to market. The vast majority of banks' government bonds are held in so-called banking books, which only must recognize a loss in the event of a default. As a result, all but one of Greece's banks passed the test, despite huge holdings of their own government's debt.

At least what the tests lack in severity they make up for in disclosure. Banks were asked to spell out their holdings of EU government bonds, and to specify what proportion is held in banking books. It is up to individual lenders to release that information, but with the exception of a handful of German banks - including Deutsche Bank - most have already done so.

This information will allow investors to make up their own minds about the sovereign risks on the banks' balance sheets. Those institutions deemed too risky will probably find it hard to access funding unless they raise more capital. And banks are bound to find the market's stress tests tougher than the one they just completed.

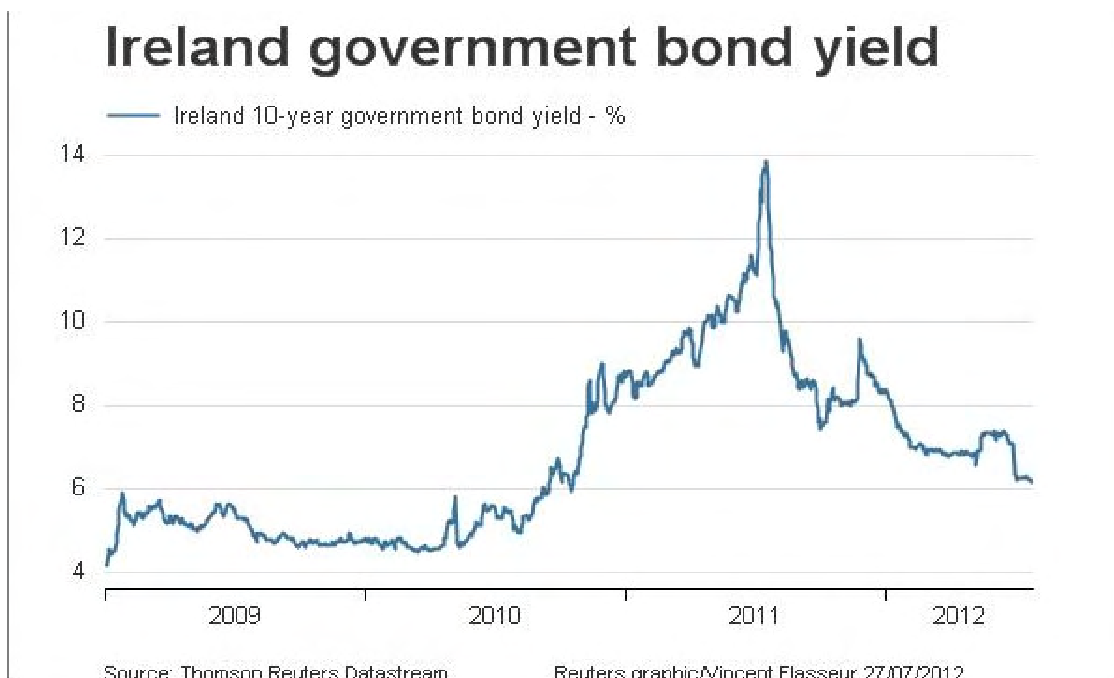
Published 23 July 2010

HOT EIRE

BY PETER THAL LARSEN

Ireland's bailout plan is a clever wheeze. The government's bank rescue has left it with an eye-watering budget deficit for 2010. But the cash cost will be spread over ten years, while other expenses aren't included in the national debt. If Ireland can persuade investors it has capped its losses, however, the manoeuvres will be worth it.

At first glance, the plan looks a model of transparency. The government is injecting a further 6.4 billion euros into Anglo Irish Bank, taking the total bailout to 29.3 billion. It is also doubling its support for Irish Nationwide Building Society by pumping in another 2.7 billion euros.



Given jittery bond markets, the resulting budget deficit of 32 percent of GDP this year is downright frightening. But Ireland will not have to borrow all the cash up front. It is recapitalising the banks with promissory notes that will be paid out over a ten-year period, allowing it to spread the cost. That explains why Ireland has postponed its next bond issue until the spring, even though it has only raised 20 billion euros, or about 12.5 percent of GDP, from the markets this year.

The government is also using sleight of hand in the recapitalisation of Allied Irish Banks. It is underwriting the lender's 5.4 billion euro capital increase and could end up owning more than 80 percent of the bank. But because the shares are owned by the National Pension Reserve Fund, the cost is not added to Ireland's national debt.

Then there is the National Asset Management Agency, set up to buy the banks' bad loans in exchange for bonds which do not count as national borrowing. This off-balance sheet arrangement will leave Ireland's sovereign debt as much as 25 percent of GDP lower than it otherwise might have been, according to the International Monetary Fund.

The Irish example shows the difficulty of combining the cost of bank recapitalisations, which may one day be sold at a profit, with excess government spending. The government's plan is largely designed to calm investors who want certainty on the cost of the crisis. If the bailout helps restore confidence it will be deemed a success. But it

cannot obscure the fact that Ireland's financial fate remains inextricably entwined with that of its banks.

Published 1 October 2010

BRING THE GIFTS

BY PIERRE BRIANÇON

Fiscal discipline isn't all about spending cuts. Ask the Greeks, who are struggling against the consequences of years of irresponsible finance. Month after month, Athens is delivering on pledges it made earlier this year to slash public expenditure as part of its European Union/International Monetary Fund bailout. In a budget on Oct. 4, the government promised to cut the deficit next year even faster than planned. It is already on track to do better than pledged this year.

But things aren't as bright on the revenue side. First, because the recession is hitting the country hard. Second, because the government is struggling to fight one of the country's major problems: the massive fraud that makes paying taxes the exception, instead of the rule.

Most western governments tend to think that cutting spending is harder than raising taxes. It's just the opposite in Greece. The overall deficit is ahead of target partly because GDP numbers were boosted by inflation, but also because the government cut spending faster than thought. This more than compensated for the actual tax revenue shortfall, which rose only 8.7 percent this year, much less than the targeted 13.7 percent.

Protests against spending cuts won't go much further than strikes or street demonstrations - so the government can go ahead with the plans. But how to make people pay taxes? Athens needs to foster a civic mindset, bring fraudsters and tax evaders back under the rule of law, and crack down hard on repeat offenders.

The government is trying. It has forced the use of cash registers and bank accounts on most businesses. It is introducing a tax amnesty - which might help if it is viewed as a genuine last chance for tax evaders to come clean rather than something that will be repeated in a few years. And it is playing tough on corruption - including among tax inspectors. But for that, it must rely on civil servants who have seen their take-home pay cut by some 14 percent in the last year. Good luck to it.

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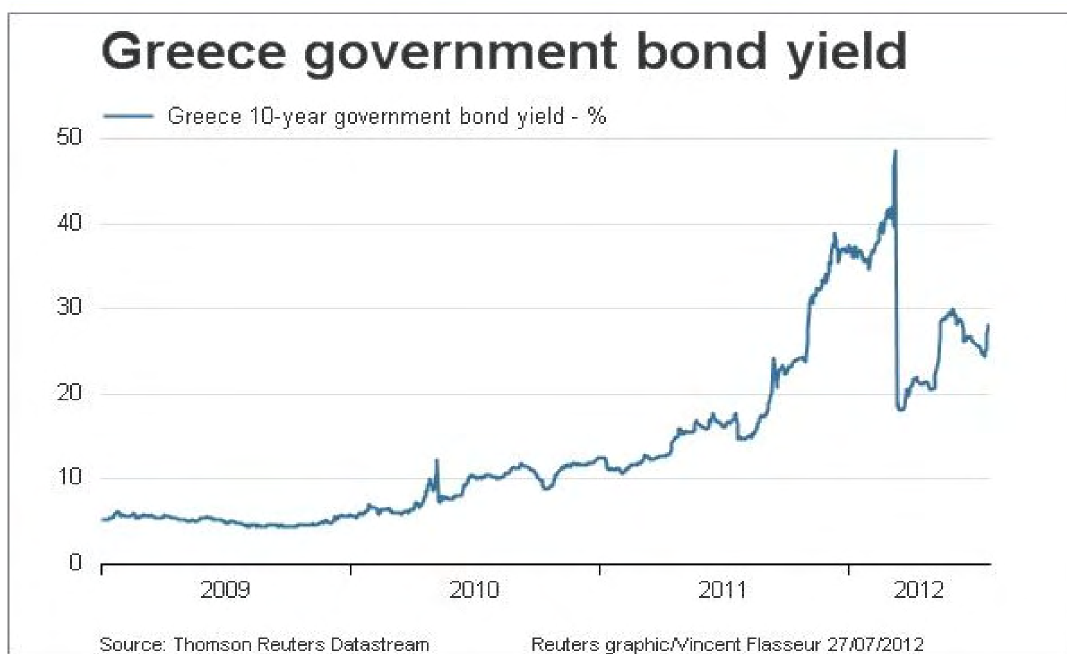


MORE THAN A PIPEDREAM

BY NEIL UNMACK

Germany's ideas for a crisis resolution regime, on which it may rally the European Union, could force losses on private creditors of rescued countries. The scheme eliminates moral hazard. But it risks destabilising markets and making monetary policy more difficult. Still, it's worth trying.

The wording of an Oct. 18 Franco-German joint statement, which paved the way for such a mechanism, is vague. Yet the implications of a sovereign crisis resolution scheme with adequate participation of private creditors are clear enough.

The idea is to replace the 440 billion euro European bailout fund with a permanent framework to manage sovereign debt crises and provide aid to troubled states. The difference, pushed for by German lawmakers, is that this time private creditors must share the pain, probably through debt restructurings or haircuts. That would be fairer than lumping taxpayers with the eventual cost of a bailout, and would impose greater discipline on wayward member states. Creditors would price government bonds taking into account their credit risk, rather than assuming that no euro country can fail because the other zone members would come to the rescue. Countries with balanced budgets would be rewarded with lower borrowing costs.

There's no arguing that such a plan would be hard to pull off. EU treaties would need to be amended, and ratified by member states. Countries that stand to lose most would be reluctant to play ball. And even the stronger members could hesitate on the principle of a pan-European body taking control of debt management - particularly since domestic

banks are large holders of government bonds. Finally, there are serious legal issues: retroactively changing existing debt could be challenged by creditors, so the new scheme would only apply to new debt, creating a two-tier market.

Germany's proposals could even be dangerous. By making explicit the prospect of a default, the euro zone might scare off investors, sparking a new crisis. And, if the difference in borrowing costs between member states were too severe, a multi-tiered euro zone would make the task of the European Central Bank more difficult. Weak countries could see their borrowing costs rise permanently, as would their banks, pushing up the cost of private sector credit. The ECB might struggle to strike a balance setting appropriate rates for both strong and weak countries.

The ECB has also recommended a crisis mechanism that would eliminate moral hazard, although it hasn't said exactly how it should be done. One idea, hinted at in a June 17 publication, is for bailout funds to rank senior to existing private sector creditors. That goes a step further than the 440 billion euro EFSF, which puts all existing debt on an equal footing. But it may not be enough. Subordinated creditors would have to mark down their debt, yet they would still benefit from bailout funds as their bonds are redeemed.

Germany's insistence on punishing bondholders makes more sense. The recent sovereign crisis was partly caused by investors' failure to price government debt correctly. Countries with loose fiscal discipline were able to fund at levels similar to their stronger peers, allowing them to borrow excessively. Take Greece, which between 2000 and 2008 ran debt to GDP levels of about 100 percent, compared to Germany's 60-73 percent. In the same period it only paid a spread over five-year Bunds that never topped 20 basis points. Investors assumed Greece's membership of the euro meant it was free of credit risk, until October 2009, when the financial crisis, coupled with an accounting scandal, forced them to reconsider. Under Germany's system investors would have punished Greece sooner - provided, of course, they were given accurate government statistics. Instead of credit spreads contracting sharply and then blowing out, euro zone bond spreads would be more stable, fluctuating within a narrower band. That doesn't mean default is impossible. There's always the chance a sudden crisis could cause a rapid deterioration in credit quality, but at least the framework for managing restructuring would be transparent and equitable, helping alleviate the contagion to other markets.

Introducing such a restructuring mechanism in the short term would be dangerous; the imbalances in the euro zone economy need to be smoothed out first to avoid a panic. But the reform would be a sensible medium-term goal for the EU to aim for.

Published 22 October 2010

MORE PLEASE
BY NEIL UNMACK

Europe may soon confront the law of diminishing returns. Greece's bailout in May came with a shock and awe package of additional guarantees and liquidity operations to soothe market panic. Ireland's 85 billion euro bailout (around 20 percent of which is actually a raid by Ireland on its own pension fund) also has some good news, but less than before. The hope is investors won't turn on other countries. The odds they will aren't great.

The bailout, provided by a medley of different lenders, gives Ireland enough money to refinance maturing debt over the next three years and recapitalize its banks. The newly recapitalised banks should be able to fund themselves from the European Central Bank and ultimately from the markets. And the state will get funds with an average seven and a half year maturity, easing immediate refinancing pressure when the programme ends. It will even have an extra year, until 2015, to reach the target of a budget deficit contained within 3 percent of GDP.

The lending terms aren't ideal for Ireland: the bailout looks both expensive, and lacking in transparency, because of the many different lenders. Still, the 5.8 percent interest rate is roughly in line with what was asked of Greece, after adjusting for the longer maturity.

The package also contains good news for other peripheral governments. Europe has decided not to haircut Irish bank senior creditors. That should make it easier for banks in those countries to roll over their debt - and keep funding their governments. Greece will also be able to extend the maturity of its loans too.

Europe has given some clarity over its future default resolution mechanism, due to be rolled out in 2013, which was spooking markets. Clauses used to bind creditors will only be included from 2013 onwards, not 2011 as hinted last week. Moreover, losses will not always be forced automatically on private sector creditors in future restructurings, but on a case-by-case basis.

The hope is that this will ease fears and prevent the steady rise in peripheral bond yields that has engulfed Portugal in recent weeks, and is now threatening Spain.

There is a slight chance Portugal can avoid a bailout so long as it sticks to its fiscal plan and the ECB keeps funding its banks. But demand for peripheral debt is weak, and has been severely damaged by recent market volatility. Investors will still be wary of lending to weak countries when the new resolution regime is introduced in 2013 if they think there is a chance of default. And even current sovereign bondholders whose debt matures after mid-2013, which is not that long away, are not out of the woods.

Firefighters raise flares as they take part in an anti-austerity rally in Athens. 28/02/2012
Reuters/John Kolesidis

If Portuguese yields don't come down, attention will increasingly focus on Spain - and that's a skittle the euro zone can't easily afford to let fall. It would then be forced into more radical measures - such as an even bigger bailout fund or really serious sovereign bond buying by the ECB.

Published 28 November 2010

REUTERS

CHAPTER 3

THREE LITTLE PIGS

The Irish bailout didn't restore confidence. Its yields continued to rise throughout the first half of 2011. So did those of Greece, which kept falling behind its targets, and of Portugal, which was seen as the next victim. The derogatory acronym PIGs was used to describe the three countries: Portugal, Ireland and Greece. In investors' minds, they were bracketed together as basket cases.

Confidence was plummeting in part because investors became increasingly concerned that the authorities didn't have a plan beyond the austerity medicine being pushed by Germany's Angela Merkel – and that seemed to be making matters worse, at least in the short term.

Warfare also broke out inside the ECB, where several hardliners led by Axel Weber, boss of Germany's Bundesbank, were queasy its bond-buying programme. Weber, who had been seen as the most likely successor to ECB boss Jean-Claude Trichet, resigned – leaving open the way for Mario Draghi. The German population became increasingly sensitised to the cost of bailing out what were often portrayed as lazy foreigners.

The spotlight was now firmly on Portugal. Its problem wasn't so much its banks, but its debts and lack of competitiveness. Its socialist prime minister, ironically called Jose Socrates, liked to say that Portugal wasn't Greece. But it was suffering from the same problems, albeit to a lesser degree. It had also experienced anaemic growth for the previous decade. The denials only undermined Lisbon's credibility. Socrates had to resign in March and, by May 2011, Portugal had accepted a 78 billion euro bailout.

Meanwhile, Dominique Strauss-Kahn, the IMF boss, got embroiled in a sex scandal which had massive repercussions for how the crisis unfolded. Not only did it deprive the IMF of an effective leader at its time of need; it meant DSK, as he was known, had to abandon his plan to become France's next president.

President of German Bundesbank Weber attends a conference of the Association of German Banks in Berlin. 31/03/2011
Reuters|Tobias Schwarz

STRIKING EARLY
BY NEIL UNMACK

Should the euro zone pressure Portugal into accepting a pre-emptive bailout, thus avoiding the weeks of drama and uncertainty that led to the Irish showdown? Over two-thirds of economists surveyed in a Reuters poll reckon the country does need a bailout. Portugal's credit default swap prices are just 20 basis points shy of Irish levels the week before the EU and the IMF came to the rescue. Lisbon might see an advantage in toughing it out. But the European Central Bank could become wary of supporting the country's banks with its unlimited liquidity.

The Portuguese government's reluctance is understandable. A bailout would be an embarrassing admission of failure, with a high political cost for the minority government of Prime Minister Jose Socrates, who found it difficult to pass his budget plans.

A bailout wouldn't necessarily help stop contagion spreading east to Spain, either. True, Spain's banks had a $108 billion exposure to Portugal at the end of March. But the main worry for Spanish banks is the 323 billion euros outstanding to the country's real estate development sector. Events in Brussels or in Madrid have a greater impact on Spanish sovereign risk than what happens in Lisbon.

REUTERS

The benefits of a bailout, meanwhile, aren't that compelling. If the cost is roughly the same as Ireland's 5.8 percentage points for loans with a 7.5 year average maturity, Portugal would save just over one percentage point in interest costs. The government could bet that over time, assuming it delivers on next year's budget, the cost of borrowing will come down.

Unfortunately, Portugal may not be able to wait that long. Its banks are locked out of international debt markets and dependent on the European Central Bank - although their ECB borrowing is about a third that of Irish banks. They need to rebuild capital and find new ways of raising customer deposits. That's hard to do in an environment of slowing growth and austerity. If Portugal delays, it risks suffering the same fate as Ireland, forced to seek a bailout after its banks suffered a liquidity crunch. There's no evidence so far to suggest this is happening, but the whole point of an early bailout is precisely to avoid it.

Published 30 November 2010

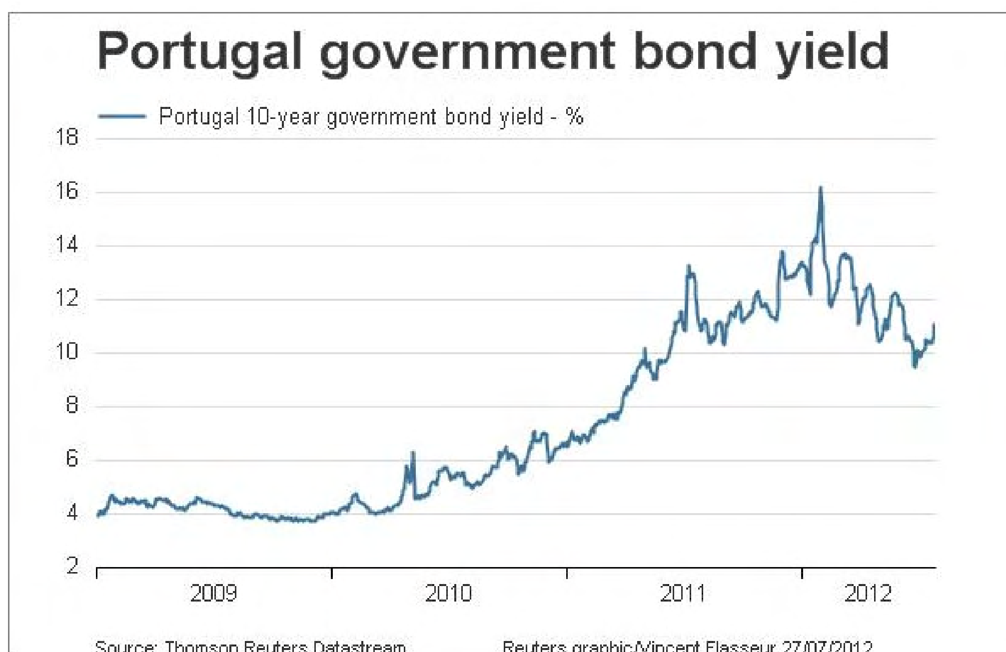
LET’S GET POLITICAL

BY NEIL UNMACK

The idea that the ECB forced the Portuguese government to seek a bailout may be a slight exaggeration but probably isn't far from the truth. Antonio de Sousa, the head of Portugal's banking association APB, says the banks' threat to boycott government debt stemmed from clear instructions from the ECB to rein in their government exposure. The buyers strike was probably a key factor in Prime Minister Jose Socrates U-turn decision to seek aid.

If that's true, the ECB certainly wouldn't have been short of good reasons. Portuguese banks are dependent on central bank funding, and Portugal had become increasingly dependent on its banks to overcome a 13 billion euro financing hump before July. The ECB's mandate is not to finance governments, and it wants to wean addicted banks off its liquidity support. A bailout was long overdue. But Portugal's political stalemate after the resignation of its prime minister threatened to delay the inevitable and push up the government's financing costs. An external prod was needed.

Also, the ECB could have been concerned about the Portuguese banking system's stability. The country's debt had suffered numerous rating downgrades, making it more expensive for banks to raise central bank funds with fast-degrading collateral. A spiral of further downgrades and soaring yields could have spooked depositors. By continuing to prop up the sovereign, the banks risked further muddying their balance sheets.



Purists might bristle at what could be construed as meddling by a central bank in sovereign matters. It wouldn't be the first time the ECB has flexed its muscles during the crisis; it may have tipped Ireland into seeking a bailout, and it fought against the new Irish government's plans to force the banks' senior creditors to take their share of losses.

But such criticism, while principled, misses the point. The ECB has been forced to take extraordinary measures throughout the crisis, such as flooding the banking system with cheap liquidity or buying government bonds. Part of it was justified by the need to ensure a proper transmission of its monetary policy. But part of the Bank's action also stemmed from the fact that governments failed to be bold enough, or fast enough, in responding to the debt crisis. The Portuguese political crisis, which made the euro zone government vacuum obvious, simply made the ECB's role even more visible.

Published 8 April 2011

ONE WAY, JOSE

BY PIERRE BRIANÇON

So there's a deal, but what's the deal? Jose Socrates, the Portuguese caretaker prime minister, has jumped the gun by announcing a bailout of his cash-strapped country by the euro zone and the International Monetary Fund, which he says will total some 78 billion euros.

Important details are still lacking - including the interest rates Portugal will have to pay for the loans. In addition, the agreement of its key participants - Portugal's political parties and euro zone member states - is yet to come. The Iberian state is only half way to a deal.

The outgoing prime minister told his countrymen that Portugal's problems weren't as severe as those in Ireland or Greece - the two countries that had to be rescued by similar EU/IMF bailouts last year. But it's hard to see what justifies this relaxed view. Quite the contrary, Portugal, which has lagged the rest of Europe since the euro's creation in 1999, must undergo painful reforms if it is to boost competitiveness and grow its economy.

In this respect, the list of things that Socrates said would not be required - like raising the retirement age or restricting public pensions and wages - is a worrying sign, even if the words he used were chosen for their political acceptability.

That said, the bailout should provide Portugal a large enough cover to implement the necessary reforms. According to Reuters' reports, 12 billion euros out of the 78 billion is to be earmarked to recapitalise the country's banks, with the aim of helping them up their core Tier 1 capital ratio to 9 percent by the year-end, and 10 percent in 2012. This is more than markets generally expected. The rest of the money, two-thirds of which will be funnelled through the European Financial Stability Facility with the rest coming from the IMF, should largely cover Portugal's funding needs over the next three years.

Sensibly, Lisbon will be given another year, until 2013, to shrink its budget deficit to 3 percent of GDP from more than 9 percent last year. This is not leniency, but realism. The impact of the deficit reduction plan on growth will adversely impact the government's revenue. Euro zone finance ministers, who will agree in mid-May on the interest rates to charge Portugal, must ensure that the cure, however painful, doesn't kill the patient.

Published 4 May 2011

NOT A LEHMAN MOMENT
BY HUGO DIXON

Restructuring Greece's debt is both desirable and inevitable, despite European Union insistence at the weekend that it is off the table. But restructuring could also cause mayhem throughout the euro zone. Indeed, many speak about a possible Lehman moment - a shock so severe that it would cause banking crises and domino bankruptcies throughout Europe.

The fears are genuine. But this should be an incentive for learning the lessons of the Lehman Brothers crisis so that, when Greece's debts are restructured, the rest of the euro zone can withstand the tremor.

Greece's debts are officially forecast to hit 159 percent of GDP in 2012. Sustaining such a burden would require so much austerity that the economy would be crushed for years. The country isn't about to run out of money tomorrow, because it is supported by a 110 billion euro European Union/International Monetary Fund programme. But the government is only funded until early next year, and will need to raise 27 billion euros in 2012.

European finance ministers are discussing ways of getting Greece over the hump. Ideas doing the rounds include making the bailout terms more generous, and providing extra cash. But there's still logic in restructuring Athens' debt soon. With every month that passes, more bailout money gets used to pay off private debt, helping those who lent to it foolishly at the expense of taxpayers in other countries.

But how to prevent a restructuring becoming a Lehman moment?

First, haircut Greece's debt by about 40 percent, so that its peak borrowings are just under 100 percent of GDP. This relatively high level will help maintain pressure on the Greek government to go ahead with a privatisation programme that could cut the ratio by another 20 points. It will also serve as an incentive to further reform. What's more, a new benchmark of 100 percent would limit contagion to other weak economies such as Ireland and Portugal - whose peak debt/GDP ratios are forecast at 118 percent and 107 percent respectively. Why would Dublin or Lisbon bother to restructure for such limited benefit?

Second, recapitalise the Greek banks. A failure to do this would destroy the country's financial system and cause depositor runs elsewhere. The answer is simple: bailout money. About 15 billion to 20 billion euros of extra money should do the trick - much less than the 130 billion euros Greece would save by haircutting its debt.

Third, recapitalise weak banks elsewhere as soon as the latest Europe-wide stress tests are published next month. The Irish have already had a capital injection; and the Portuguese will get one as part of the bailout plan currently under negotiation. That leaves French and German banks, which have some $541 billion of exposure to peripheral economies, and Spain's savings banks, which could cause trouble given that Madrid itself isn't totally out of the woods. If Greece restructures its debts, there won't be any prizes for others who twiddle their thumbs.

Finally, provide banks with medium-term funding if they can't raise money in the market. It's often forgotten that government guarantees for banks' medium-term debt were a key element in shoring up the global financial system after Lehman went bust. Injecting capital on its own is not enough. Look at how Irish banks still struggle to raise funds.

Ideally this would be the job of the European Financial Stability Facility, the zone's bailout fund. But sadly, this idea has been caught in a game of pass the parcel. The ECB's attitude is that providing medium-term funding is the EFSF's task, while governments think it's the central bank's role. The result is that Portugal's banks, for example, won't receive medium-term funding from either. Instead they will get guarantees from their own government, which won't really do the trick given its poor credit.

If Europe carries on like this, it may well face its own Lehman moment.

Published 9 May 2011

EARLY EXIT, SERIOUS PROBLEMS
BY PIERRE BRIANÇON

For obvious reasons, Dominique Strauss-Kahn didn't meet with Angela Merkel as originally planned on Sunday. This illustrates one of the damages his New York arrest will inflict on Europe's long-drawn debt drama. Euro zone finance ministers were due to talk and maybe decide early this week on the final version of the Portuguese bailout, a sweetening of the Irish package, and a possible overhaul of the Greek one. Now they've lost the man who not only was instrumental in involving the International Monetary Fund in the euro zone periphery's rescue plans, but who could also have helped them bridge their own divisions by the force of his diplomatic skills. In particular, his rapport with the German chancellor helped the euro zone move at times when it looked paralysed.

Dominique Strauss-Kahn, head of the IMF, departs a New York Police Department precinct in New York. 16/05/2011
Reuters|Mike Segar

His political ambitions in France would most probably have led Strauss-Kahn to leave his IMF job before this summer anyway - in barely a month. But he will be incapacitated during the month the institution needs a leader most. In the first year of their debt crisis euro zone leaders have constantly relied on him to bring Germany's chancellor to the common table. He convinced her a year ago that demanding Greece met short-term tough fiscal targets was unrealistic and counter-productive. This week he was counted upon to press the case for reasonable interest rates on Portugal and Ireland, and to send the signal that Greece could still count on the conditional tough love of its lenders if, as widely thought, its turnaround programme is off track.

Euro zone leaders must now do without him. But the questions the IMF would have faced after his departure would have had to be confronted anyway. Isn't it high time for a

non-European to head the institution, given the shift of power in the world economy? What should be its new doctrine? Strauss-Kahn led the IMF away from what he criticised as the group think of the so-called Washington consensus, but no new think has emerged on the best ways to tackle global imbalances - the IMF's original mission. Beyond the personal travails of a man and the euro zone's existential crisis, these are the problems the IMF shareholders - still dominated by America and Europe - must now seriously look at.

Published 16 May 2011

TRIPLE HAZARD

BY HUGO DIXON

Moral hazard is the clue to solving the euro crisis. The idea that entities don't learn lessons unless they feel pain is valid in the euro zone - but only if the blame is shared properly. The mess isn't just the responsibility of profligate Greeks, but also of foolish banks and hypocritical Germans and French. Each needs to suffer.

One of the main reasons the region's financial crisis is so intractable - with endless wrangling over what is the best way forward - is because the different players haven't fessed up to their own sins. There is therefore a tendency to proclaim their own virtue and pin the blame on others. This makes it hard to come up with a fair settlement.

The main fault line is over whether it is the borrowers (Portugal and Ireland, as well as Greece) who were to blame or the lenders. If, like the German tabloid press, one thinks that it is just the borrowers' fault, the natural remedy is to crack down on them by imposing stringent austerity programmes in return for bailouts. If one is too lax, they will sin again.

But the lenders were also foolish. That's something the population in peripheral countries, especially Ireland, increasingly appreciates. Germany and France, though, whose banks are exposed to the euro zone periphery, haven't faced up to this truth. This causes its own moral hazard: unless banks suffer write-downs as a result of debt restructuring, how can they be expected to learn the appropriate lessons?

Moral hazard also has a third dimension: the hypocrisy of the big, rich countries. Germany and France were responsible for undermining fiscal discipline early in the millennium by breaking the Maastricht Treaty's rules on borrowing. It is therefore appropriate that they should suffer too, largely through making more cheap loans to Greece and other struggling countries.

A combination of more austerity, haircuts for creditors and further soft loans from rich countries will probably be what eventually solves the euro zone crisis. But the region would get there faster if everybody admitted their own guilt.

Published 20 May 2011

WRONG AND WRONG

BY PIERRE BRIANÇON

Barring a last-minute surprise, it looks like the International Monetary Fund's shareholders will make the mistake of choosing Christine Lagarde, France's finance minister, as the institution's managing director. It's probably too late to ask them to think twice - but they should anyway.

Christine Lagarde attends a news conference following the release of the IMF's annual report on the U.S. economy, at the IMF headquarters in Washington. 03|07|2012
Reuters|Jason Reed

The IMF's heavy involvement in the euro zone rescue process was controversial from the start. The European Central Bank and some euro zone members - including, ironically, France - were originally opposed or reluctant to call for the organisation's help. And as the potential size of the euro zone debt mess has become more apparent, some members of the IMF board are questioning the size of its commitment. There may come a point when the IMF needs to reassess its role in Europe. Can one trust Lagarde, who has been an interested participant in the crisis from the start, to make fair and balanced decisions on the IMF's action?

The IMF is also, and should be, a place of vigorous intellectual debate about the direction of economic policies. It's hard to see Lagarde forming a personal view, say, on the desirable level of inflation, a debate launched a couple of years ago by IMF chief economist Olivier Blanchard. Or lightly orienting the organisation away from the Washington consensus, as Dominique Strauss-Kahn did. This is not to say that an IMF

boss should have a blind ideology, trying to force the reality into his or her preconceptions. But strong views and original ideas, yes. In four years as finance minister, Lagarde has barely opined on global financial imbalances, China's currency policy or capital controls - all issues crucial to her future role.

Finally Lagarde leaves France's budget deficit in the same state as Portugal's - although it still enjoys the same ratings as Germany. Will she be the best placed to call for the euro zone to abide by strict fiscal discipline? And will she recuse herself in the - unlikely, but not impossible - event that France one day has to turn to the IMF for help?

Lagarde certainly will not be the worst leader the IMF has ever had. But in the current moment, the institution needs more than a passable consensus-builder.

Published 07 June 2011

CHAPTER 4

BEYOND BUNGA BUNGA

The acronym PIGs was sometimes written as PIIGS. In that version, the second "I" came to stand for Italy; and the "S" for Spain. Portugal, Ireland and Greece were occasionally called the Little PIGs because they were small economies that could be easily bailed out. But Italy and Spain were much bigger and, when the spotlight turned on them, the crisis became far more threatening.

Madrid's main problem was similar to Dublin's: a bust property bubble that had destroyed its banks' balance sheets. But it also shared with Portugal and Greece a competitiveness problem. On top of this, it had astonishingly high unemployment.

Throughout late 2010 and early 2011, its socialist Prime Minister Jose Luis Rodriguez Zapatero was in denial. The reforms he undertook to the banks and the economy were too little, too late. But they still provoked an uproar among the people, spawning the "indignado" movement, under which mostly young people occupied public squares. Realising he was losing credibility, Zapatero agreed in July to call an early election that November.

But the real drama was across the Tyrrhenian Sea in Rome. For years, investors had turned a blind eye to Italy's high debt, corruption and rigid labour market because it was a rich country with a low budget deficit. Many found the bunga bunga sex parties of Silvio Berlusconi, the right-wing prime minister, amusing.

But then in July Berlusconi's tense relationship with his finance minister Giuliano Tremonti took a turn for the worse. Yields on 10-year bonds nudged above the 6 percent level for the first time in 14 years. The government was forced to ram through an austerity package to restore temporary calm.

Meanwhile, Greece was going from bad to worse. The austerity programme was driving the Greek economy deeper into the mire. An emergency euro zone summit in July sketched out a second bailout plan for Greece. A key innovation was that private sector bondholders would have to contribute.

August was a rough month in the markets. The controversial ECB bond buying programme that had been effectively dormant for four months was reactivated in early August to help Italy and Spain. Before doing so, Trichet sent uncompromising letters to both Berlusconi and Zapatero laying down the reforms they needed to make to their economies.

But the bond purchases did not stop the rot, in part because investors doubted that the ECB hard its heart in the programme. Before the month was out, yields were climbing again.

TIME FOR ARRIVEDERCI
BY HUGO DIXON

Silvio Berlusconi really must go. It's no longer about abuse of power and bunga bunga sex parties. His continuation as Italy's prime minister could drive the country into a financial death spiral. His own supporters are shaken and the public is afraid. But the left-wing opposition is behaving responsibly, so there's some hope.

Italy pulled back from the brink - slightly - on July 12. After nudging above 6 percent, the yield on 10-year government bonds fell back to a still uncomfortable 5.6 percent. Part of the explanation is that the opposition agreed to a fast-track parliamentary vote on the government's new austerity programme. The multi-year fiscal squeeze of more than 40 billion euros should therefore be approved by the end of the week.

But this is not enough. Berlusconi is in virtual open warfare with Giulio Tremonti, his finance minister. Even though things have been patched up for now, the idea that this dysfunctional government could serve out its term until 2013 is troubling. Italy could lurch from mini-crisis to mini-crisis - with the borrowing cost on its debt, currently at 120 percent of GDP, ratcheting ever higher. The more Rome is perceived by financial markets to have fallen behind the curve, the bigger the fiscal adjustment will have to be to get it back on track.

Man looks at painting called "Silvio & Ruby" made with plastic bags and cellotape by Israeli artist Reifenberg at Edward Cutler gallery in Milan. 06/04/2011
REUTERS/Alessandro Garofalo

Italy is too big to bail out. But it is a rich country - which can be bailed out by its people. That also means Italians have a lot at stake if the country goes down the tubes. In the past they have been far too complacent about their country's political and economic mess. The mini-scare over the last few days is, therefore, salutary. It may help

REUTERS

concentrate minds about the need to make some medium-sized sacrifices now - such as front-loading the austerity programme, much of which will only kick in from 2013 - in order to avoid bigger sacrifices in the future.

Now, there's the small question of how to ease Berlusconi out of power. He's extremely unlikely to fall on his sword. Indeed, he has continued to use the remaining vestiges of his influence to save his own skin rather than the country's - as witnessed by his recent attempt to pass legislation to delay the payment of a 750 million euros fine in connection with a 20-year-old scandal. So Berlusconi will have to be pushed out by members of his own right-wing coalition, which has a thin majority. There might just be a chance of this happening if market jitters continue.

Then, of course, there's a question of whether Berlusconi would be replaced by anyone better. There are, broadly speaking, two options: a grand coalition led by a technocrat such as Mario Monti, the former European Commissioner; or early elections. The first might be a reasonable outcome, securing some short-term stability. But a technocratic government wouldn't have a mandate to push through the long list of structural reforms and constitutional changes that are needed to kick-start growth in this sluggish economy. For that, new elections would be required.

Elections in the heat of the euro zone crisis would certainly be risky. The markets could get the real heebie-jeebies if the campaign turned demagogic. The current crisis could trigger a realignment of politics, and produce a new centrist coalition or even a catharsis of the system. But it could just as well lead to a stalemate, with no clear winner.

That said, Italy will have to confront its political problems at some point - and sooner is better than later. A little more fright now might be just what's needed to shake the electorate out of its complacency.

Published 13 July 2011

VAGUE BUT POTENT

BY FIONA MAHARG-BRAVO

They're still gathering, but will they go anywhere? Spain's protest movement, known as the indignados or Movimiento 15-M, is mustering sympathy, but it has been hard to see what it stands for, save for a general discontent. The movement is probably too disperse to shape the debate in the forthcoming general elections, which may be moved up to November. Still, politicians cannot afford to ignore them.

The peaceful movement is not an ideological revolution and doesn't have clear leaders. Their assembly-based organisation, where decisions must be unanimous, makes it hard to elaborate concrete alternative propositions. But in a society still polarised by political beliefs, this means they appeal to a large group - nearly 80 percent of Spanish people believe the protests are justified, according to a June Metroscopia poll.

Even so, the opposition, conservative People's Party tends to downplay the movement. This isn't too surprising. PP voters are more loyal: 86 percent of PP voters in the last election would vote for them again. That proportion is only 51 percent for the ruling socialist party, the PSOE, according to a survey for El Pais newspaper. The trend was already clear in the last regional elections in May, and may be more pronounced in the general elections.

Spanish PM Zapatero gestures during a news conference in Madrid. 21/11/2011
Reuters| Andrea Comas

This explains why the socialists have started making marginal concessions in their direction, including new limits to the amount banks can reclaim from those that default on mortgages. The new socialist leader, Alfred Perez Rubalcaba, said he supports electoral reform and a tax on banks. This won't be enough to win them over.

The PP, currently credited with a 14 points lead in the polls, would be wise to listen too. Indignados have yet to shape the debate on the really key economic reforms, such as the overhaul of labour markets. But they have the power to make quite a lot of noise, not least on the media front. It is in the government's interest - not to mention its duty - to engage protestor and explain why reform is necessary. This is something the socialists have so far failed to do, and they are paying the price.

Published 15 July 2011

VICIOUS SPIRALS

BY HUGO DIXON

Europe is dancing with danger. The region's leaders have been consistently behind the curve when addressing problems from Italy to Greece. The more credibility shrivels, the more they need to do to restore confidence. This week's summit is the last good chance to stop the rot.

A vicious cycle is in operation. As investors get increasingly anxious about the ability of governments to solve the euro zone's debt problems, borrowing costs shoot up - and that makes it even harder to solve the problems.

The vicious cycle is now whirling in a frightening number of different places. The first concerns Greece, which needs a second bailout. Europe's leaders have been going round and round trying to find a way of making sure that private-sector creditors bear some of the pain. The fact that as of last Friday officials were still tossing around three very different schemes suggests that they still haven't got their act together.

The politicians only now seem to be giving serious consideration to how to minimize the fallout if the rescue involves a Greek default. Greek banks, which are up to their eyeballs in their own government's debt, would need to be recapitalized. A way also needs to be found to ensure that they can fund themselves. Given that these issues are technical, one wonders whether Europe has really given itself long enough to crunch out proper solutions.

The problem isn't just that the politicians can't agree among themselves; they've also been in open warfare with the European Central Bank which has been resisting any private-sector involvement. Comments by Ewald Nowotny, the Austrian central bank governor, suggest that the ECB's opposition to a Greek default might finally be softening. But the impression left by the months of wrangling is that the euro zone is a dysfunctional entity that will always be doing too little too late.

Meanwhile, in Italy, Silvio Berlusconi's antics can no longer be considered a joke. His fractious government has been unable to cut its deficit rapidly enough. Although parliament has passed an austerity programme, the damage had already been done - and the markets are now demanding more, largely because the austerity has been delayed. Bond yields are likely to ratchet higher until Rome delivers the goods. The worry is that by the time the government makes its next step, the market will have moved on even further.

Similarly, Spain's lame-duck government is still seen by investors to be in denial about the problems in its savings banks. Last Friday's sham European bank stress test, after which Spain's central bank said the country's banks didn't need to raise any capital, will probably damage credibility even more. The best hope is that a new government led by the conservative opposition will grip the problem. But unless there are early elections, that won't be until next year. In the meantime, a huge amount of damage could be done.

At Thursday's summit, Europe's leaders have got to prove their doubters wrong - and tackle all these problems. If they come up with more half-baked solutions, the markets will punish them severely.

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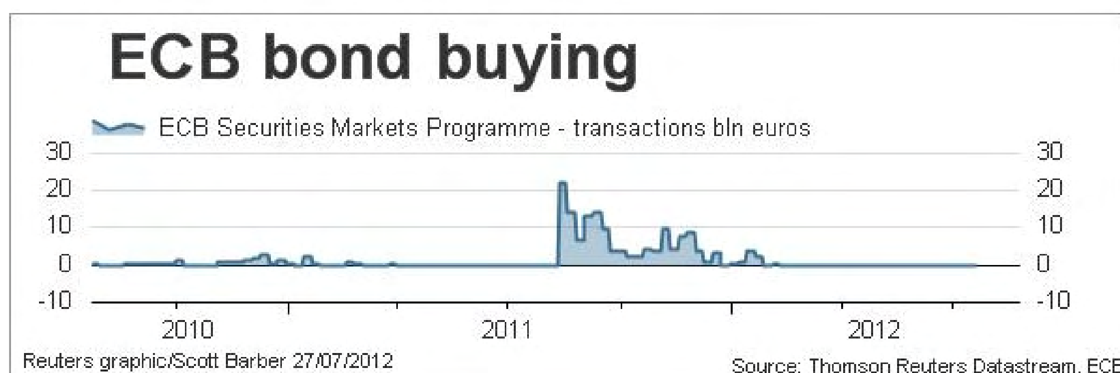


PIG IN A POKE

BY HUGO DIXON

A deal was better than a disaster. But last week's planned rescue of Greece has the astonishing by-product of increasing its debts. It also lets private creditors off lightly while making taxpayers elsewhere in the euro zone pay through the nose. It doesn't even mark the end of the crisis.

True, the sustainability of Greece's debt has been improved. Its government will receive 109 billion euros of new 15-30 year loans from the euro zone at an interest rate of only 3.5 percent. Private-sector creditors will also swap or roll over 135 billion euros of existing bonds into new longer-term instruments.

But this private-sector involvement comes at a huge cost. Because the European Central Bank put the fear of God into politicians about the consequences of a Greek default, private creditors have been handled with kid gloves. Sure, they are going to suffer 21 percent losses compared to the face value of their bonds (assuming a 9 percent discount rate). But that's much less than the 50 percent haircut that is needed to put Greece's finances onto a stable footing.

What's more, the financial jiggery-pokery used to corral the creditors actually means Greece's debt will rise. This is mainly because Athens will need to borrow 35 billion euros to buy collateral to partially guarantee the new bonds it will give its creditors.

The deal also envisages Greece borrowing 20 billion euros to buy back debt with a face value of 32.6 billion euros. The price, equivalent to 61.4 percent of face value, is another sweetheart deal for the creditors. A more muscular approach would have cut them to

half face value.

Taxpayers in other euro zone countries, by contrast, are digging deep. Imagine they applied the same 9 percent discount rate that private creditors think is appropriate. Their new 109 billion euros of loans would be worth only 54 billion euros, according to a Breakingviews analysis. In other words, they are the ones taking a 50 percent haircut.

Taxpayers elsewhere might chip in too, if the International Monetary Fund makes a contribution. But it would be surprising to see the Washington-based institution pay a third of the total bill as it did with Athens' first bailout. Non-European countries, even the United States, are balking at the amount of money the institution is pouring into Greece.

Two factors could tilt the deal back in favour of the taxpayers and away from the private-sector creditors. First, the euro zone leaders hinted in their communiqué that Greece might be asked to give them collateral too. As well as providing taxpayers with protection, the collateral would give Greece an added incentive not to veer off its economic fitness programme. Given the length of the programme and the fact that the Greek opposition has refused to buy into it, there is a sizeable risk Greece could stray.

Second, private-sector creditors will still be on the hook for 150 billion euros - or 115 billion euros once the collateral is subtracted. This means that, if and when it becomes apparent that Athens can't bear its debts, it will be possible to give them another, more severe, haircut.

But even if these mitigating factors kick in, the deal is very much a second-best option. It would have been better to have done a proper restructuring of Greece's debts now. A forcible swap of all the private sector's bond holdings, currently around 200 billion euros, at 50 percent of face value would have cut the need for new official funding to Greece to virtually zero.

In the Middle Ages, a common scam was to sell a cat in a bag while pretending it was a far more valuable pig. Buyers who didn't look inside the bag first were conned. In those days, the word for bag was poke. Taxpayers outside Greece are being sold a pig in a poke.

Published 25 July 2011

FELLOW SPANIARDS

BY HUGO DIXON

Here's a speech Mariano Rajoy, Spain's leader of the opposition, should give to the people:

Fellow Spaniards

You know me as a cautious man. Indeed, much of the political advice I receive these days is how I should run a cautious election campaign. The socialists are so discredited that all I need is to avoid hostages to fortune and the job of prime minister will fall into my lap.

Although this advice is tempting, elections aren't just about getting elected. They are also about getting a mandate to govern. Spain faces a risk of being sucked into the euro zone crisis. We are already on the edge of the vortex. Quite apart from that short-term danger, we have low competitiveness and a 21 percent unemployment rate. Fixing all this is going to require sacrifice.

The immediate priority is to convince the bond markets we are "ahead of the curve". That means removing lingering doubts that we will hit our deficit targets and that our savings banks have strong enough balance sheets. The widespread perception that we have not done enough on either score has undermined our credibility in the markets, pushing up both the government's borrowing costs and those of our banks. That has had a debilitating knock-on effect throughout the economy.

I ask the outgoing government to remedy these defects even in their final four months in office. But, if they fail to, we will have to cut spending and inject more government funds into the savings banks if we win the election.

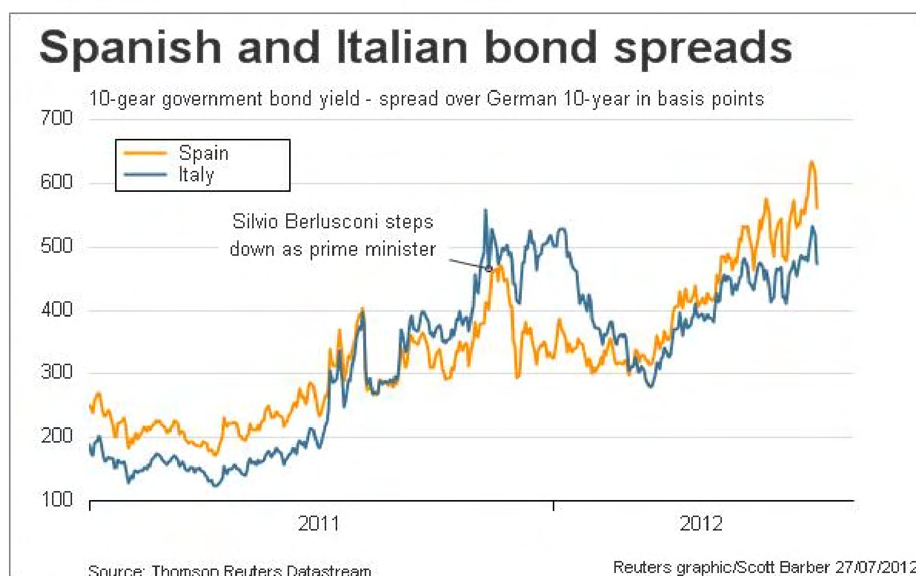
Some will ask why we have to dance to the tune of the markets. The answer is simple. As a country, we have borrowed a huge amount of money, though fortunately the government's own debts aren't so large. Those who borrow in the markets have to keep their creditors happy.

We can't even rely on help from our euro zone partners if we get in a pickle. Even a month ago, one might have had a different view. But Italy's political shenanigans have put that country's finances in the markets' cross-hairs. Our fate and that of our fellow Latin country are seen as tied together. As a package, we are certainly too big to bail. Last month's euro zone summit made that clear. The region's bailout fund was made more flexible, which is somewhat useful, but not made any bigger.

Italy should be both a warning and a spur to action. Our goal should be to disentangle our fate from Rome's so that, even if it gets into trouble, we will not get dragged down. The way to do that is to convince the markets that we are taking action.

If is, of course, not enough to avoid this immediate danger. We also have to tackle

unemployment. Unfortunately, there's no pain-free solution. Our labour costs are too high and have to come down. If they do, investment will flow again and new jobs will be created. The main way of achieving this will be to give business more freedom to set wages as well as to fire people who aren't performing.



But, even if we implement these changes, unemployment won't drop as quickly as it did between 1996 and 2004 when it halved from 22 percent. Our own debts will weigh us down for many years. With the European Central Bank likely to keep pushing interest rates up, it's not going to get easier to carry them. Meanwhile, much of the rest of the global economy is sick, so we can't expect a surge in exports. This is not an optimistic speech. But once we've been through the pain, Spain will emerge fitter and healthier. Some advisors have told me that if I made this speech, I would lose a lot of votes. But I would much prefer you know what you are voting for so that, if I am elected, the people are signed up to the difficult changes we need to make.

Published 1 August 2011

TAKING AIM
BY PETER THAL LARSEN

Did Standard & Poor's spur the European Central Bank into action? There was no direct link between the rating agency's decision to strip the United States of its triple-A status and the euro zone debt crisis. But fears of market turmoil triggered by the downgrade may have prompted the central bank to restart its bond-buying programme. The intervention has calmed nerves. However, it is only buying time.

The ECB would have preferred euro zone governments to step in. However, they cannot do so until the European Financial Stability Facility is given the authority to buy

sovereign debt in the secondary markets - a process that will take several months. With Italian and Spanish government bond yields soaring - and most of Europe's politicians on holiday - the ECB rode to the rescue.

Quite how big that rescue is remains to be seen. On paper, the ECB's Securities Markets Programme is unlimited. By being ambiguous about the size of its chequebook, the central bank could bully markets into accepting much lower yields. But making a dent will require a big outlay: Italy alone still has to issue debt worth about 100 billion euros this year.

Besides, the ECB has so far insisted on sucking in bank deposits to neutralise the effects of buying around 74 billion euros worth of Greek, Irish and Portuguese debt. Unless the central bank decides to effectively start printing money, this will limit its ability to buy bonds in much larger quantities. The prospect of intervention helped drive down Spanish and Italian bond yields on Aug. 8 - though in both cases yields on 10-year bonds are still higher than they were a month ago.

In the meantime, the ECB is open to other risks. One concern is that its intervention will relieve the pressure on Italy to stick to its deficit-cutting measures. The expansion of the EFSF could also be derailed if one euro zone member fails to approve it.

Finally, the EFSF itself may not be up to the task. Reforms to the bailout facility are designed to increase its lending capacity to 440 billion euros. That's enough to finance the current Greek, Portuguese and Irish bailouts, recapitalise Spain's banks, and buy all the bonds that Spain and Italy still plan to issue this year. However, it cannot afford a full Italian bailout.

Besides, the EFSF's ability to borrow depends on the guarantees provided by euro zone members - particularly those with triple-A credit ratings. There is no direct reason why the U.S. downgrade should trigger similar steps in the euro zone - but it does make France's membership of the triple-A club look increasingly shaky.

A French downgrade would force Germany to guarantee an even larger part of the bailout fund - or force the EFSF to accept a lower rating and higher borrowing costs. This would further complicate the rescue. Still, given the U.S. experience, the euro zone would be in good company.

Published 8 August 2011

CUTTING THE CORD

BY PETER THAL LARSEN

The crisis of 2008 is repeating itself in reverse. Three years ago, European governments stepped in to save the banking sector. Today, the euro zone's indebted sovereigns are threatening to spark a full-scale bank panic and possibly even another credit crunch. Europe's lenders must be insulated from their governments and vice versa. Five radical steps could break the bank-sovereign "doom loop".

Step 1: Solving the capital conundrum

Europe's weaker banks need capital if they are to be prevented from pulling the system down. The most pressing problems are Spain's cajas and certain Italian lenders that barely scraped through Europe's latest stress tests. With private markets effectively closed, and Italy and Spain scarcely able to afford bailouts, the solution is to repurpose Europe's sovereign bailout fund to inject capital directly into banks.

Eurogroup Chairman Luxembourg's PM Juncker and former ECB president Trichet attend a conference organised by EU40 at the EU parliement in Brussels. 27/03/2012
Reuters | Yves Herman

While the European Financial Stability Fund can already make loans to countries for the purpose of recapitalising banks, this shift would be controversial: it would mean governments ceding control of financial institutions to a pan-European body. Still, the EFSF could get a big bang for its buck: boosting the core Tier 1 capital ratios of Europe's

90 largest lenders by 1 percent would cost 100 billion euros - less than the price of Greece's second bailout.

Step 2: Solving the funding freeze

European banks, especially those in Italy and Spain, risk a liquidity crunch if wholesale markets do not reopen to them by the autumn. And even if they are able to issue longer-term debt, it is likely to be expensive. That could choke off credit to the economy.

The answer again lies in reinventing the EFSF to offer lenders temporary funding guarantees, thereby lowering their financing costs. The idea, first proposed by analysts at Morgan Stanley, has worked before. The United States and several European countries restored calm in the wake of Lehman Brothers' collapse by guaranteeing bank funding. Besides, guarantees would represent less of a drag on the EFSF's lending capacity than actual loans.

Step 3: Preventing bank runs

Even with capital and wholesale funding worries addressed, banks would still be vulnerable to a loss of confidence by depositors. After all, bank deposits are ultimately guaranteed by a bank's home country. When savers fret about their government's finances, they tend move their cash - something that is particularly easy in the euro zone. Greek banks have seen their deposits shrink by roughly 15 percent since the beginning of 2010, European Central Bank data shows. But if there was a single, pan-European deposit scheme, savers would be more likely to stay put. The scheme could be financed through a levy on bank deposits, although the EFSF could, again, provide an interim backstop.

Step 4: Say no to banks propping up their governments

Regulators have unwittingly cemented the sovereign-bank link by encouraging lenders to hold larger reserves of liquid assets - mainly in the form of sovereign bonds. Banks in troubled countries have also come under pressure to prop up their government by buying even more of its debt. To break this potentially fatal embrace, banks should be subjected to strict exposure limits on their exposure to any single country's bonds.

Step 5: A pan-European regulator with teeth

If these steps were taken, the risk is that the sovereign-bank co-dependency would re-emerge, but on a pan-European level - with the creation of a new breed of even larger "too big to fail" institutions. Preventing that requires unsecured creditors to face real losses if a bank falls over. Big banks must also be structured so that they can be safely wound down. It is hard to see how that can be achieved without a single financial supervisor for the euro zone - something national regulators would no doubt resist. But the United States provides a good model, with the Federal Reserve and the Federal Deposit Insurance Corporation overseeing the system with the help of regional bodies. The embryonic European Banking Authority could be adapted for this purpose.

The catch

These steps would not instantly fix the sovereign debt, large deficits and stagnant growth that plague the euro zone. But removing banks from the equation would lift one large potential fiscal burden on governments. And banks that were no longer shackled to sovereign fortunes would find it easier to extend credit to the economy.

As ever, the problem is politics. This plan would mark a big lunge forward in European integration. Politicians and voters that currently balk at lending to other countries would have to be persuaded to help underwrite the euro zone's financial system via a beefed up EFSF. But if the euro zone's squabbling and dilly-dallying leaders have a better alternative, let them get on with it.

Published 19 August 2011

RIGOR MORTIS

BY PIERRE BRIANÇON

Euro zone governments must recognise that extremism in the pursuit of austerity is no virtue. Portugal this week became the latest country to tighten its budget, hoping to meet deficit-reduction targets agreed in its bailout programme. Italy's politicians are struggling to agree on a new round of austerity, demanded in August by the European Central Bank before it agreed to buy the country's bonds.

Greece, meanwhile, looks incapable of meeting its own targets. That's partly due to the government's seeming incompetence at bringing in tax revenue. But the country is also caught in a self-defeating spiral where austerity compounds an already-severe domestic recession.

There's no arguing that heavily indebted euro members must reduce their budget deficits. But from Italy to Ireland, the main challenge is growth - the lack of which has pernicious effect on debt. Austerity fuels recession, enlarges deficits, and in turn makes it more difficult for countries to lighten their debt burdens.

The latest numbers show that the economies of Portugal and Greece are in recession, Ireland's is flat, while Italy's and Spain's are barely budging. In all of these countries, additional austerity plans - on top of tough measures already enacted - will defeat the ultimate purpose.

Besides, structural reforms are more important than quick-fix cuts in public spending. Yet while sustainable growth depends on effective structural reform, results take time. Reforms also bring upfront financial cost. For example, the poor quality of higher education is one of Greece's most serious obstacles to growth. That requires public investment. Structural reforms can't be equated to simplistic formulas such as liberating labour markets or paring welfare spending - both of which, incidentally, raise near-term recessionary pressures.

With another recession looming, accelerating fiscal tightening in countries already engaged in austerity plans could make it impossible for them to get out of their troubles. Structural reforms should take precedence over short-term austerity fetishism. Persistence in the pursuit of growth is no vice.

Published 01 September 2011

CHAPTER 5
SUPER MARIO BROTHERS

Greece hadn't lost its capacity to shake the euro zone to its foundations. With its economy in free fall, political support for further austerity measures was draining away. Papandreou announced a desperate gambit in October: a referendum. The snag was that he hadn't squared this plan with Merkozy.

Markets took another dive. Merkozy gave Papandreou a dressing down at a summit in Cannes, suggesting for the first time openly that Greece could leave the euro. The Greek PM then rescinded his referendum plan and soon after resigned, paving the way for a national unity government, led by technocrat Lucas Papademos.

But the damage had been done. As Greeks speculated about the possible return of the drachma, capital flight from the country's banks took off. Investors and ordinary citizens became increasingly worried about other countries leaving the euro too, triggering capital flight from Italy and Spain and pushing up their bond yields.

Rome was the main focus. As Italian yields rose above 7 percent in November, Berlusconi's political support collapsed and he was forced to resign. Former European Commissioner Mario Monti, nicknamed Super Mario, was appointed to lead a technocratic national unity government. He rapidly passed a new reform programme, including an overhaul of the pension system, designed to save Italy.

Mario Draghi, meanwhile, had replaced Trichet at the head of the ECB. Was the wily Italian going to be more flexible than his predecessor? The euro zone's fate was now said to hang on the Super Mario Brothers.

Draghi was not prepared to help before governments had signed up to more fiscal discipline. This, too, was what Merkel wanted. She campaigned for a new "fiscal compact", which would give more teeth to the existing rules requiring countries to rein in their deficits and debt. At a summit in December, Merkel got her way -- with one exception. The UK refused to sign up. Although this didn't stop the other countries proceeding with their new treaty, it soured UK-EU relations.

Now Draghi made his move. Fearing a credit crunch across the euro zone, the ECB announced it would lend banks unlimited amounts of cheap three-year money. In the first of two long-term refinancing operations (LTROs), lenders gorged on 490 billion euros just in time for Christmas.

FORWARD THROUGH ENGINEERING
BY IAN CAMPBELL

What might Europe's comprehensive solution to its crisis look like? Breakingviews offers a tongue-in-cheek draft of a possible communique:

We announce here the three main elements of our plan. The EFSF II augmented haircut SPIV BRIC bail-in plan offers a solution to the euro zone's difficulties that is comprehensive, effective and as breathtakingly simple as the plan's name implies.

1. EFSF II. In order to guarantee the solvency of euro zone sovereigns the new plan will create leveraged structures to multiply by four or five times the firepower of the 440 billion euros provided by euro zone members to the European Financial Stability Facility.

EFSF II will guarantee the first 20 to 25 percent of losses investors would suffer in the unlikely event that either Spain or Italy were to default on their obligations. This use of leverage draws on the best advances in financial engineering and is in no way comparable to past difficulties with housing debt, especially given that the solvency of the governments is utterly unquestioned, except by markets.

Investors in fresh issuance by Italy and Spain would only suffer losses in the extraordinary event that writedowns on these countries' debts were to exceed 25 percent - a likelihood with almost zero probability in any euro zone member.

2. Augmented writedown. The second element of the plan involves an unavoidable increase in the writedown on Greek debt to 50 percent from 21 percent. This exceptional step, certain not to be repeated in any other zone member, is only required because of major failings in Greek statistical calculations before it entered the zone, and for a decade thereafter. The essential writedown will be entirely voluntary. Banks will welcome the losses they suffer given the need to assure Greece's viability.

3. SPIV-BRIC bail-in. To improve liquidity and demand for euro zone sovereign debt a special purpose investment vehicle (SPIV) is to be created using a subordinated loan from EFSF II. The IMF will augment the SPIV and emerging economies will invest in it, for their good and especially Europe's. The SPIV will buy sovereign bonds in the secondary market, leveraging international support for the zone.

The plan is comprehensive because it will generate purchases of euro zone sovereign debt in both primary and secondary debt markets. With this additional liquidity, the solvency of euro zone governments is assured. We believe we can confidently say the euro zone crisis is over. All growth and competitiveness problems in the euro zone are hereby rectified. Market anxiety was always excessive. A little engineering is all that was needed.

Published 27 October 2011

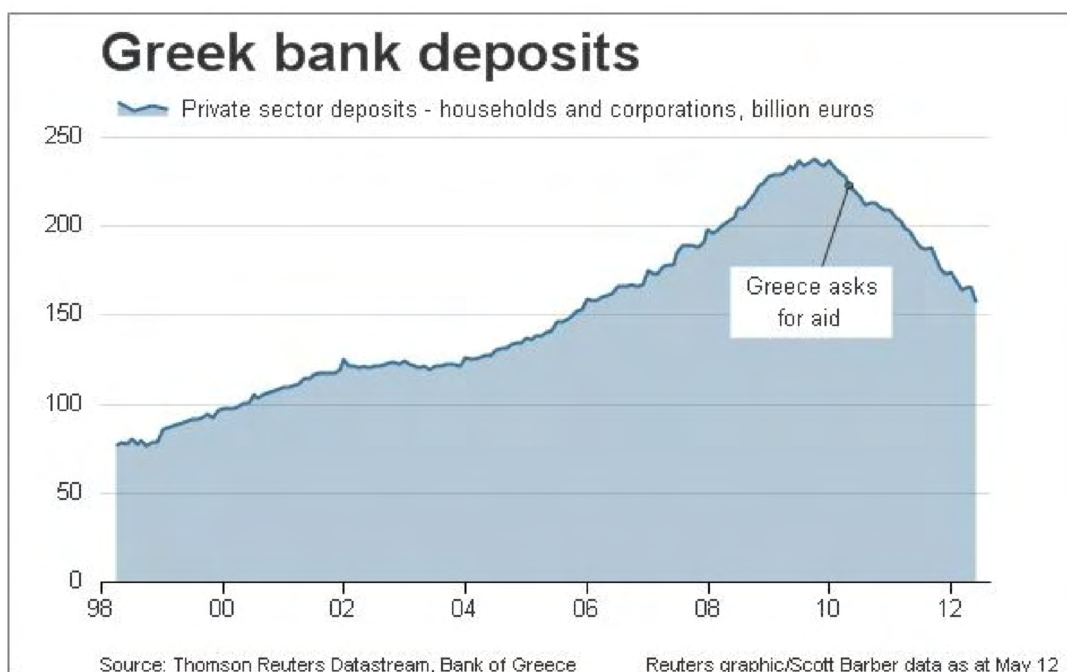
REUTERS

A SURFEIT OF DEMOCRACY
BY HUGO DIXON

The relief rally following last week's euro summit is well and truly over. Greece's planned referendum on the latest bailout, announced as polls show its citizens reject it, has thrown the whole pack of cards up into the air. Bank runs, disorderly default, a Greek exit from the euro and vicious contagion elsewhere no longer look like wild scenarios.

Quite what George Papandreou thought he was doing by calling a referendum is unclear. The Greek prime minister seems to have taken his European partners by surprise. The relentless criticism at home about how he has handled the crisis and the pressure from the rest of Europe for permanent monitoring of the government's actions may have caused him to snap.

Last week's planned debt restructuring and bailout isn't ideal for Greece. Even in 2020, the country's debt is still projected to be 120 percent of GDP. The people will also have to endure continuing austerity. But the package did come with the promise of 130 billion euros of new loans from Athens' European partners, of which 30 billion euros was earmarked for recapitalising the country's banks.



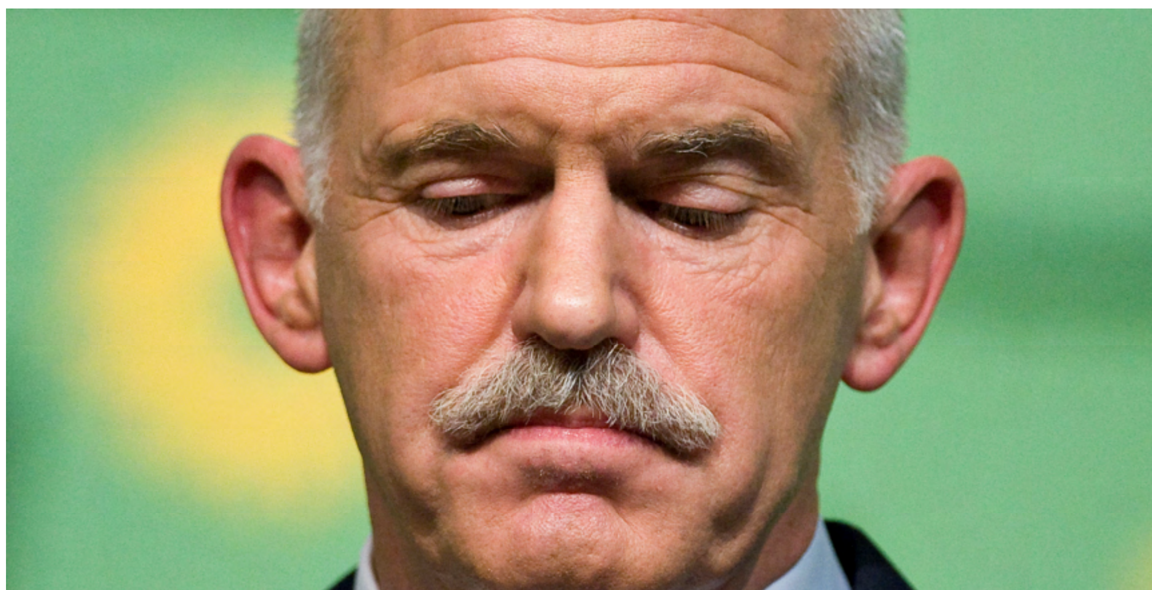
If the Greeks vote No in a referendum that is likely to take place in January, that aid may also disappear. Given that Athens only has enough money to pay its bills until early next year, it could then be forced into a disorderly default. The country's banks would then go bust because they hold huge sums of Greek government debt, causing the economy to plunge further into the abyss. Greece would have little choice but to quit the euro. But that would bring with it mayhem not least because Athens is still running a primary

budget deficit. With nobody willing to provide it with funding, the government would have to embark on even more severe austerity.

Papandreou may hope that such a nightmare scenario will shock his fellow citizens into voting Yes. But such scare tactics could actually trigger problems before the Greeks even have a chance to vote. Depositors have been gradually taking their money out of Greek banks. Faced with the possibility of a No vote, an exit from the euro and the bankruptcy of their banks, a bank run could accelerate. As of August, there was still 189 billion euros of deposits in Greek banks. The European Central Bank would then have to decide whether to allow the central bank of Greece to continue making emergency loans to the country's banks or force their bankruptcy even before the referendum.

Contagion to the rest of the euro zone would be far more vicious than anything seen so far. Italy is the weakest point. Rome's own political shenanigans have already rattled the markets. The country's 10-year bond yields have risen to 6.2 percent, a rate that is probably not sustainable in the long run.

Last week's package came up with a plan to leverage the European Financial Stability Facility, the euro zone's bailout fund, with the idea that it would then be big enough to provide some sort of safety net for Italy if needed. The snag is that this is based on untested financial engineering, including raising money from China. After Greece's bombshell, the EFSF could face a tougher job to sell its own bonds.



Former Greek Prime Minister Papandreou reacts during speech at Germany's Green Party party convention in Kiel. 25/11/2011
REUTERS/Morris MacMatzen

Now, of course, there are other scenarios and possible contingency plans. Papandreou hasn't said what the Greek people will be asked to vote on. It is possible he will come up with a crafty question that secures a Yes vote. It's also conceivable that his government will fall before the referendum, allowing another prime minister to take over.

Meanwhile, the rest of Europe may look into their own abyss and decide that they are prepared to continue supporting Greece both through its referendum process and even after a No vote, in order to avoid a disorderly default. They may decide to regroup and force a steeper haircut on Athens' creditors in order to bring its debt load down to a more sustainable level. Finally, the ECB still hasn't turned on its big bazooka. It could theoretically stem the rot for example by itself lending to the EFSF, although this would involve swallowing all its principles.

One thing, though, is clear. Papandreou's bombshell has tipped the euro crisis back to square one - or worse.

Published 1 November 2011

CHAOTIC CATHARSIS

BY HUGO DIXON

Chaos, drama and crisis are all Greek words. So is catharsis. Europe is perched between chaos and catharsis, as the political dramas in Athens and Rome reach crisis point. One path leads to destruction; the other rebirth. Though there are signs of hope, a few more missteps will lead down into the chasm.

The dramas in the two cradles of European civilisation are similar and, in bizarre ways, linked. Last week's decision by George Papandreou to call a referendum on whether the Greeks were in favor of the country's latest bailout programme set off a chain reaction that is bringing down not only his government but probably that of Silvio Berlusconi too.

The mad referendum plan, which has now been rescinded, shocked Germany's Angela Merkel and France's Nicolas Sarkozy so much that they threatened to cut off funding to Greece unless it got its act together – a move that would drive it out of the euro. But this is probably an empty threat, at least in the short term, because of the way that Athens is roped to Rome. If Greece is pushed over the edge, Italy could be dragged over too and then the whole single currency would collapse. So, ironically, Athens is being saved from the immediate consequences of its delinquency by the fear of a much bigger disaster across the Ionian Sea.

Italian bond yields, which were already uncomfortably high, shot up after the Greek referendum fiasco. Berlusconi was forced to pacify Merkel and Sarkozy at the G20 meeting in Cannes by agreeing to a parliamentary confidence vote on his government's lackluster reform programme as well as to monitoring by the International Monetary Fund. The humiliation in Cannes, where Berlusconi's finance minister pointedly failed to back him, could be the final nail in the PM's coffin.

The end of the Berlusconi and Papandreou eras should, in theory, be a cause for celebration. Although the Italian PM's behavior has been scandalous, whereas the Greek PM's has not been, they have both led their countries deeper into debt. They are also

both members of political castes that have enfeebled their nations for many years. Getting rid of them could be the start of a renewal process.

The snag is that it's not certain that what comes next will be better. In both countries, where I have spent much of the last fortnight, the best outcome would be national unity governments committed to rooting out corruption and cutting back overgenerous welfare states. This could happen either before or after snap elections. Unfortunately, the old political castes die hard. They could continue bickering over who suffers the most pain and who gets the top jobs until they are staring into the abyss – or even fall in.

Many in the rest of Europe, meanwhile, would probably love to push them over the edge if they were themselves strong enough to take the strain. But Merkel, Sarkozy et al have been criminal in their lack of preparation. The so-called comprehensive plan agreed to at the euro summit of Oct. 26 was another case of too little, too late. Not only was the plan for recapitalising Europe's banks only about half as big as it should have been as well as foolishly delayed until next June; the scheme for leveraging up the region's safety net, the European Financial Stability Facility, is full of holes. This became clear at Cannes, where Merkel had to admit that few other G20 countries wanted to invest in it.

The whole of Europe is now in a race against time. The Greeks have to get their act together before the rest of Europe is ready to cut them loose. The Italians have to restore credibility before they get sucked into a vortex from which they can't escape. And the rest need to put in place really strong contingency plans in case Athens and Rome continue to let them down. If everybody runs very fast, the last week could be the beginning of the catharsis. If not, chaos beckons.

Published 7 November 2011

Italian PM Monti looks on next to German Chancellor Merkel during a news conference at Villa Madama in Rome. 04/07/2012
Reuters|Max Rossi

SUPER MARIO BROTHERS
BY HUGO DIXON

The Super Mario Brothers need to work together to save Italy and the euro.

Even if Mario Monti can form a strong government in Italy, the euro zone is vulnerable to bank runs and a deflationary spiral. Stopping that is the role of Mario Draghi, the European Central Bank's boss. The zone needs vigorous supply-side reform but looser monetary policy. With Silvo Berlusconi gone, the duo and Germany's Angela Merkel should try to forge a new grand bargain based on this.

Last week witnessed both the Italians and the Greeks dragged to the brink, they looked into the abyss and disliked what they saw. The two countries have or are in the process of forming national unity governments led by technocrats. This is a step in the right direction. But dangers abound.

The biggest risk is of a visible bank run. There has already been massive deposit flight in Greece as savers fear that the country could get kicked out of the euro – a scenario which is still real despite Lucas Papademos' appointment as prime minister. But so far there have been no queues outside branches as there were with the UK's Northern Rock in 2007. If that were to happen, television pictures would be relayed across Europe in seconds potentially provoking copycat runs.

Even without visible deposit runs, euro zone banks are debilitated. Many have already suffered runs in the wholesale markets: U.S. money market funds have sharply cut supplies of short-term cash; and hardly any bank has been able to issue unsecured bonds since the summer. The banks are able to get money from the ECB but only for up to a year. Their funding problems now look set to suffocate industry via a renewed credit crunch.

Meanwhile, the banks' difficulties are exacerbating governments' funding problems. France's BNP revealed this month that it had cut its holdings of Italian debt by over 40 percent in the previous four months. Other banks could follow suit, thinking it is better to take smallish losses now rather than get caught in a Greek-style debt restructuring later. This means that, even if Monti gets a mandate to push through structural reforms – which need to be more radical than those planned by Berlusconi – Rome could struggle to finance itself on decent terms. Ten-year bond yields, which ended last week at 6.5 percent after shooting up to 7.6 percent, need to come down to 5 percent for the country's debt to be sustainable.

The euro zone may already be in a double-dip recession. A renewed credit crunch plus extra austerity demanded of governments – France was the latest to tighten its belt last week – could push it into a fairly deep one. The snag is that the more governments raise taxes, the faster economies shrink, which in turn makes it harder for them to balance their books and so piles further pain on the economies.

Many European nations lived beyond their means for years. They enjoyed excessively generous welfare states and didn't allow the free market to operate properly. So big changes are needed. But the current policy mix isn't working. A new treatment is required that puts more emphasis on the long-term reforms – such as pushing up pension ages, making it easier to hire and fire, reforming bloated civil services and privatisation – and less on short-term pain.

Such a new policy mix would require action not just by governments but by the ECB. The central bank is now the only realistic source of mega funding after many non-euro countries made clear at the G20 summit in Cannes this month that they thought the zone should solve its own problems. China, meanwhile, indicated that it would only help in return for unpalatable quid pro quos such as extra power at the International Monetary Fund.

Draghi and his colleagues at the orthodox central bank need to make three radical changes. Germany, the euro zone's conservative main paymaster, would need to back the changes to give them political cover.

First, the ECB should offer banks longer-term cash to prevent an imminent credit crunch. Governments should simultaneously require their banks to hold more capital so that they have adequate cushions to withstand the hard times ahead. The 106 billion euros of capital injections agreed at last month's euro summit should be doubled in line with what the IMF recommended. That might then reassure the ECB that it wasn't lending to potentially insolvent banks.

Second, the central bank should be prepared to act as a lender of last resort to governments which are following responsible policies. The Lisbon Treaty prevents it from lending directly to states, but that shouldn't stop it leveraging up the European Financial Stability Facility, the euro zone's bailout fund. The EFSF would then have the firepower to help Italy and Spain if needed. So long as Berlusconi was presiding over a dysfunctional government, it was sensible to avoid bailing it out. But provided Monti can deliver, that would no longer be relevant.

Mario Draghi, President of the European Central Bank (ECB), addresses the media during his monthly news conference at the ECB headquarters in Frankfurt. 05/07/2012
Reuters | Alex Domanski

Finally, the ECB should prepare to launch "quantitative easing". At the moment, inflation in euro land is 3 percent. But it is soon likely to head below the 2 percent level that the ECB defines as price stability. Given that official interest rates are now 1.25 percent, there's not much scope for further rate cuts. But the ECB could print money to buy government bonds and other assets, in the same way that the U.S. Federal Reserve and the Bank of England are doing.

The ECB does have a government bond buying operation already. But this is a long way from quantitative easing. First, it is small: 0.8 percent of GDP; the U.S. and UK programmes are 16 percent and 18 percent of GDP respectively. Second, the ECB mops up all the money it creates when it buys bonds whereas the Fed and the Bank of England inject extra cash into the economy. The main benefit of a similar operation would be to help restore the competitiveness of struggling economies by weakening the euro which, despite the crisis, is astonishingly strong at $1.38.

Such a grand bargain might sound rational. But is it possible to orchestrate a deal between 17 different countries and a fiercely independent central bank? Not yet. But just

as pressure from the markets and Italy's euro partners has pushed Rome into doing things it wouldn't have contemplated even weeks ago, pressure from the markets and the rest of the world may soon push the euro zone to be more creative too. The Super Mario Brothers need to get cracking.

Published 14 November 2011

EEGS IN ONE BASKET

BY PETER THAL LARSEN

The euro zone needs a new acronym. For the past three years, PIGS has served as a catchall for the cash-strapped states on the single currency's periphery. But now that the crisis has moved to the core, a change is overdue.

PIGS has proved surprisingly durable. When it was first coined, citizens of Portugal, Ireland, Greece and Spain were understandably upset at being lumped together in such a derogatory way. Yet as Ireland and Portugal followed Greece in seeking bailouts, their similarities outweighed historical differences.

Some felt the acronym was self-fulfilling, giving attention-deprived speculators a handy shortlist from which to select their next sovereign victim. However, its survival was also an accident. When Italy got into trouble earlier this year, it slotted smoothly into the slot previously reserved for bailed-out Ireland. Politically sensitive bodies avoided the zoomorphic insult by reshuffling the letters to create the GIPS.

Now that the crisis has hit the euro zone's core, this approach will no longer do. But coming up with a new acronym poses several problems. First, there is the challenge of accommodating lots of extra letters: France, Belgium, Finland and the Netherlands are all feeling the strain. Second, apart from Austria, there's a shortage of new vowels. That makes little Estonia – which only joined the single currency in January – an attractive candidate.

Even then, though, the task looks hopeless. Throw in Slovenia and Slovakia, and the best option is SPIFFINESS. This hardly sums up the gloomy mood. And it doesn't include Greece, which is where all the trouble started.

A better idea might be to start with the one remaining euro zone member that isn't under attack from the bond markets. Andrew Balls, head of European portfolio management at PIMCO, now describes the euro zone states being shunned by investors as EEGs: Everyone Except Germany.

It's an accurate reflection of the panicked state of markets. And the acronym has the advantage of being short. In the euro zone farmyard, it's time to forget about the PIGS and start counting the broken EEGs.

Published 21 November 2011

HARAKIRI BRITISH-STYLE
BY HUGO DIXON

The UK's self-immolation beggars belief. The government's clumsy attempt to extract concessions from euro zone countries in their time of need has set off a chain reaction which could undermine Britain's interests and even drive it out of the European Union.

It's not clear what David Cameron thought he was doing at the European summit in the early hours of Dec. 9 when he demanded vetoes on financial regulation in the EU. Was the prime minister asking for something he knew was unacceptable so that he could return to Britain and parade as a hero in front of the euroskeptics in his Conservative party? Or did he just vastly overestimate his negotiating position, thinking that the euro zone countries were so desperate to save their single currency that he could bounce them into accepting the British demands by presenting them with a take-it-or-leave-it offer in the middle of the night? If it was the former, Cameron was cynically putting his personal interests above those of the nation; if the latter, he was just extraordinarily inept.

Cameron did little to win allies for his position, not even circulating his list of proposals in advance of the summit, according to Reuters. Even worse, he put Britain in the position of seemingly being prepared to blow up the single currency if he didn't get his way. In fact, Cameron didn't have the power to stop the 17 euro zone countries from agreeing to sign a new treaty committing themselves to fiscal discipline. They just sidestepped the existing EU treaty. What's more, they got all nine of the other countries which are part of the EU but not the single currency to sign up too. So all Cameron achieved in the middle of the night was to irritate Britain's partners massively and isolate the UK 26-1.

Where does London go from here? One approach would be for Cameron to carry out his next threat: to try to stop the euro zone countries from using the European Commission and the European Court of Justice to police their fiscal discipline on the grounds that these institutions belong to all 27 countries. It's not clear whether this is a legally winnable position, but pushing it would certainly make Britain look petty and further antagonise other European countries.

Meanwhile, members of Cameron's euroskeptic wing will find it hard to hide their desire to see the single currency wrecked – something that could further madden those whose livelihood depend on it.

Unnecessary battle

None of this was remotely necessary. The euro zone countries weren't trying to impose fiscal discipline on Britain, only on themselves. In fact they weren't trying to impose anything on the UK. True, France has often seemed like it wanted to undermine the City of London's position as a financial center. But until now, it has had zero success because the UK has always managed to assemble enough allies to support its position. In future, though, that can no longer be guaranteed. France's President Nicolas Sarkozy may find

he has allies if he wants to push through regulations that disadvantage what he calls his "British friends". The risk of an inner club acting as a caucus and imposing its wishes on the UK has increased significantly.

The danger extends beyond financial services. Britain has been the main campaigner for free markets within the EU in recent decades. Although it hasn't achieved everything it wanted, there have been notable successes such as creation of the so-called single market. Germany which, in some ways, is closer to Britain than France in its economic thinking supported these initiatives. But Angela Merkel isn't going to be so keen to do the UK favors after Cameron snubbed her. The same goes for Italy, whose new Prime Minister Mario Monti was a natural ally for liberalisation given his passionate advocacy of the single market.

The British PM, meanwhile, has been reduced to the pathetic position of saying that the Netherlands, a fine but rather small country, will protect its interests in the single market. But even the Dutch finance minister has said: "The situation for the UK is very serious…If you don't have a seat at the table, you don't participate."

The biggest worry is that a vicious cycle develops – in which the euro zone squeezes the UK off the top table because of its lack of cooperation, London behaves increasingly like a spoiled brat because it is frustrated by its lack of influence, and this further antagonises the big continental powers. Life could ultimately become so uncomfortable that Britain leaves the EU. It would then lose the automatic right of access to the world's largest market. Although the rest of Europe might still let British business and finance operate on its side of the English Channel, it would largely dictate the rules of engagement.

Such an outcome would be disastrous for the City, British industry and UK foreign policy. Why would the United States, China, the Middle East and India want to deal with London if it had no friends in Europe? It would also be harder to persuade foreign business to locate in the UK if it had only second-class access to the single market.

Not all lost

But it's not too late to retrieve the situation. The business and financial community can and should put pressure on the government to find some face-saving position that allows Britain to move on in harmony with the rest of Europe. Something along the following lines might work: the UK would reverse its opposition to the existing EU mechanisms being used to enforce fiscal discipline on the euro countries while also saying how much it wanted to support them in their time of need; the other countries would then say how what they were doing would in no way undermine the single market while also asserting that they had no intention of imposing any new taxes on the UK, including the so-called Tobin tax on financial transactions, unless London wanted them. The euro zone wouldn't actually be giving anything away as the UK already has a veto on new taxes. But such a declaration would sound good.

Getting to such a position wouldn't be easy given that Cameron would have to eat his words and France would have to be persuaded to let Britain back into the fold. But

Sarkozy may no longer be France's president in five months; and the UK government may not be totally impervious to argument.

One pressure point is the Liberal Democrats, the minority partners in the coalition. They think of themselves as pro-Europeans and are aghast at Britain's far from splendid isolation. Their leader, Nick Clegg, who is also the deputy prime minister, foolishly backed Cameron's negotiating strategy without thinking through how it was likely to play out. He has now performed a U-turn, saying he is "bitterly disappointed" at the outcome. That, of course, is not the same as leaving the coalition. The LibDems will be reluctant to go down that route because they are scared of being slaughtered if there is a new election. But the chances of a collapse of the government have definitely risen.

Another pressure point, paradoxically, may be Boris Johnson, the euroskeptic mayor of London. Cameron may well have hardened his line on Europe because he didn't want to be outflanked by Johnson, a hugely popular figure in the Conservative party. But the summit's outcome isn't in the interest of the City and therefore isn't in the interest of London. If bankers can bring this point home to Johnson, who is an old friend of mine and whom I informally advise from time to time, he may soften his line – allowing Cameron to take a more accommodating position too.

Salvaging the situation will be tricky. But Britain doesn't have an interest in being at loggerheads with the rest of Europe or vice versa – especially when the region's worst financial crisis in a lifetime is still raging.

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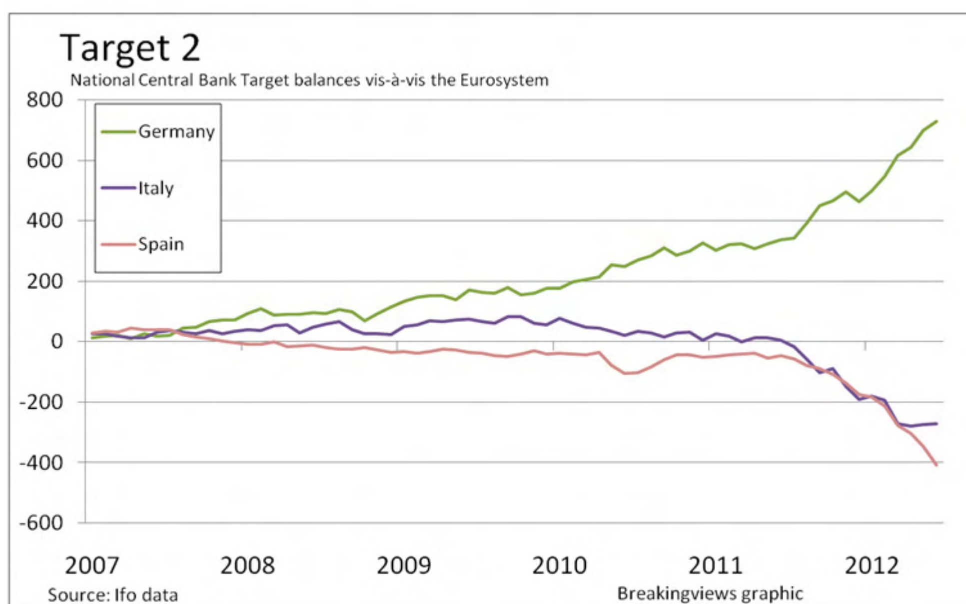

CHAPTER 6
FALSE DAWN

The New Year brought relative market calm, as the ECB's LTRO magic did its work. Banks used the cheap money not just to shore up their own balance sheets; but also to buy Spanish and Italian government bonds. Both countries' yields fell below 5 percent.

Just before the New Year, Mariano Rajoy had taken over as Spain's prime minister. The conservative leader had won a decisive election in November and he now embarked on a reform programme: cutting the deficit, reining in Spain's overspending regions and liberalising the labour market. Monti, too, pushed through a second package of reforms in Rome – this one designed to get the economy growing.

There was even some good news from Greece. Its long-running second bailout worth 130 billion euros was finalised in February. When private-sector creditors took a big haircut the following month, it did not trigger market mayhem.

A second LTRO in February – this time worth 530 billion euros – added to the general mood of self-congratulation. With so much liquidity sloshing around the financial system it became easy to forget that the underlying problems hadn't gone away. Large parts of the eurozone economy were in recession; the people in southern Europe were tired of austerity; and the people in the north were tired of bailing out their neighbours.

Even the new governments in Spain and Italy were showing signs of fatigue. Rajoy flunked his reform of the banking system and shocked his euro zone partners by unilaterally declaring a softer budget deficit target than originally agreed. Monti diluted and postponed his reform of Italy's labour market. Meanwhile, in Greece and France elections loomed.

HARD TIMES AHEAD
BY NEIL UNMACK

Italy needs markets to keep the pressure up. Mario Monti's liberalisation reforms are already producing a backlash from vested interests. Opposition will be even tougher when he tackles labour rules. Eventually, Italy needs lower bond yields. But for now, 6 percent yields are just what are needed to scare Italians into backing change.

Monti's biggest test to date has come from a decree announced on Jan. 20 to promote competition in service sectors and open up closed professions, such as notaries and pharmacists. The Bank of Italy reckons greater competition could boost the country's GDP by 11 percent over the long term, but that won't placate many Italians who stand to lose from the reforms today. Strikes by taxi drivers and truckers (who are also complaining about hikes in fuel prices) have blocked roads across Italy. A wave of further action is planned in coming weeks by lawyers, pharmacists and petrol-station owners. The strikes could sap Italian's reform zeal, or worse, spark unrest. Battles on the streets aren't the only challenge; the decree must be approved by parliament within 60 days. Any suggestion that it is being watered down would spook markets.

The government faces an even stiffer challenge in coming weeks as it seeks to tackle Italy's lopsided labour market. The current system crimps productivity by penalising employees on short-term contracts, who are easier to fire and have fewer benefits than permanent employees. Monti needs to strike a deal with Italy's unions, whose members are keen to protect their privileges. The unions' political links give them an edge: the largest union, CGIL, is linked to the centre-left Democratic Party, whose support Monti needs to keep a parliamentary majority.

Monti has one big ally – bond markets. Ten-year bond yields have narrowed by a full percentage point since he took office in mid-November. They fell 20 basis points after the liberalisation decree was announced on Jan. 20. Over time, Italians will need to see yields come down further to believe their sacrifices are worth it, particularly as the country enters a recession. But for the moment, they are probably at just about the right level to keep the pressure up.

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GOING TO PIECES
BY PETER THAL LARSEN

The global financial system is becoming more national. Three years after Western taxpayers were forced into a mass bailout of banks, Western lenders are in full retreat, encouraged by regulators and governments.

In the two decades leading up to the financial crisis, national borders became steadily less important in finance. The crisis made it clear that nationality does matter, because

domestic taxpayers ended up supporting banks, including their far-flung operations. The crisis also showed that banks had too much leverage.

European banks are now leading a backwards charge. According to Barclays Capital, euro zone lenders had $1.2 trillion of assets in emerging markets in mid-2011 – double the amount just seven years earlier. A significant chunk of those assets are supported by the parent bank's capital and funding. With capital scarce and funding costs high, retreat is the only option.

Europe's banks are also pulling back on the business of lending in dollars, which were often borrowed from U.S. money market funds. After U.S. investors fled from Europe last year, that business looks too risky. Though the funds may be returning to the euro zone, banks are likely to remain wary.

Post-crisis regulation is contributing to de-globalisation. Capital-short banks in Europe and elsewhere have sold foreign businesses. And the UK government has accepted the recommendation of its Independent Commission on Banking to ringfence domestic retail banking operations, making foreign and investment banking units less appealing. The U.S. Federal Reserve's latest stress tests effectively punished big U.S. lenders with extensive European operations by requiring them to be able to withstand a euro zone meltdown. And Canada and Japan fear the U.S. Volcker rule, which bans proprietary trading, will force lenders out of foreign sovereign debt markets.

At least the Basel Committee's new bank capital regulations are designed to be implemented on a global basis. But other financial rules are less universal. For example, Europe is pushing ahead with the Solvency II framework for insurers, even though the United States is showing no sign of following suit.

Governments also want financial institutions to concentrate their efforts at home. Politicians no longer see any advantage in hosting global financial champions, but stress the value of lending to local small businesses and consumers. Commerzbank declared last year that it would stop lending outside Germany and Poland. Austrian banks are under orders to limit their exposure to central and eastern Europe. Some European lenders are also under pressure to buy their home governments' bonds.

Does this de-globalisation matter? The adjustment is clearly painful for countries that had come to rely on cheap capital from the West. The Institute for International Finance predicts that net capital flows to emerging markets this year will drop by almost a fifth to $746 billion – only slightly above the post-credit crunch low of $643 billion. This will make credit more expensive, perhaps hindering economic growth.

But the financial fragmentation of the past three years should not be exaggerated. Capital can still flow freely in and out of most developed countries. The world's most ambitious cross-border financial experiment, the euro zone, is still just about intact. The only explicit national capital controls have been imposed by countries such as Brazil, which were worried about attracting too much hot foreign money – not losing it. And cross-border trade has resumed its upward trend, generating foreign exchange surpluses which China and others can still invest around the world.

In any case, some retreat was probably in order. The crisis showed the foundations of international finance were less solid than previously thought. And financial internationalisation does not always make sense. A recent study of seven western economies – the United States, Japan, Germany, UK, France, Italy and Spain – by the consultancy Oliver Wyman showed that each is roughly in financial balance, and does not necessarily need to either export capital or seek foreign financial support.

Nevertheless, the reversal is significant. For several decades, many Western governments embraced liberalisation and globalisation, in the belief that free markets would allocate resources efficiently and stimulate growth. That orthodoxy has been thoroughly discredited. But the cracks now appearing in the global financial system could lead to more undesirable fissures. A global outbreak of protectionism could be even more destructive than the financial crisis.

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Spain's Prime Minister Rajoy speaks during the World Economic Forum on Latin America in Puerto Vallarta. 17/04/2012
REUTERS/STRINGER Mexico

READING THE FINE PRINT
BY FIONA MAHARG-BRAVO

Spain's 50 billion euro bank overhaul is not as impressive as it first appears. The reform, which generated big headlines when it was unveiled last week, is a step in the right direction. But as lenders start to disclose the impact of new rules, it's becoming clear that the cleanup isn't as extensive as the government claims.

The plan seems straightforward: banks must set aside an additional 25 billion euros this year in order to boost reserves on bad property loans. They must keep an extra 15 billion euros of capital to cover additional potential losses. And they must earmark a further 10 billion euros for loans that are currently performing but might go bad in future.

Scratch the surface, however, and the numbers are less striking. The 15 billion euros of additional capital is not actually new cash that the banks must raise, but can be met from any buffer that exceeds existing regulatory ratios. Most of Spain's listed banks already have capital ratios well above the 8 percent regulatory minimum.

What's more, banks can use existing stocks of generic provisions, which they were required to set aside during the boom, to cover the new provisioning needs. Banks still hold about 6 billion euros of these provisions, according to Cheuvreux estimates.

Take BBVA. Spain's second-largest bank faces a bill of 4 billion euros from the cleanup. That includes an extra capital buffer of 1.2 billion euros – equivalent to another 37 basis points on its capital ratio. But at the end of 2011, BBVA's capital ratio was 9.7 percent – comfortably above the regulatory minimum. The bank also has 460 million euros of generic provisions on its books. After tax, the hit to its bottom line is just 1.6 billion euros - less than half the headline figure. The story is much the same at CaixaBank and Santander.

Of course, not all of Spain's banks have the same reserves of capital and generic provisions. Weaker and unlisted lenders may have to raise fresh capital, possibly from the state. But the government's claims to have comprehensively dealt with its banks' bad debt problems are far from convincing.

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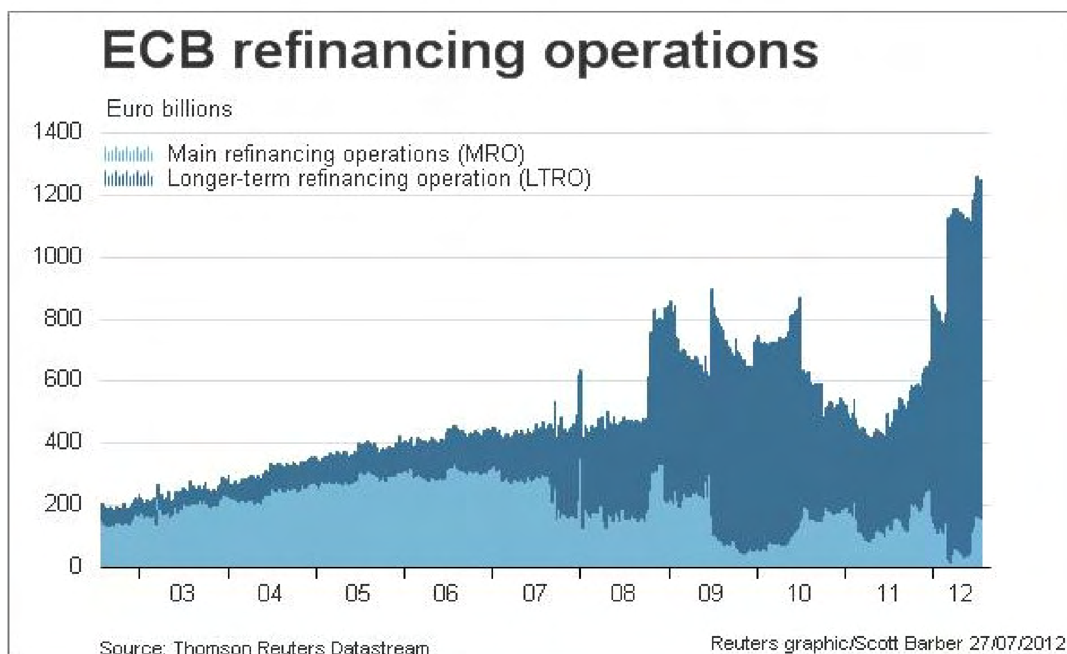

CAN YOU KICK IT?

BY PETER THAL LARSEN

Mario Draghi has given Europe's banks an adrenaline fix. The European Central Bank's decision to offer lenders cheap three-year loans has averted a Lehman-style financial system collapse and helped revive markets. But this cure is a far from a panacea.

The ECB's Longer Term Refinancing Operation has scored several significant successes. To start, the willingness of the central bank to step in has helped calm fears that a dearth of liquidity would cause the sudden failure of a big institution. Investors who fled the bank funding market last summer are slowly returning; European lenders have issued more unsecured bank debt in 2012 than in the entire second half of 2011, according to Morgan Stanley.

Also, banks which can count on three-year funding have more time to shrink their balance sheets. And the central bank's funding is cheap – an interest rate of just 1 percent. That amounts to an official subsidy of the sector. Suppose lenders draw down another 500 billion euros at the ECB's next LTRO at the end of February, taking the total to 1 trillion euros. Then each 100 basis points knocked off banks' funding costs boosts annual income by up to 10 billion euros. The extra earnings should help banks rebuild capital buffers.

Like any emergency medical procedure, however, the ECB's move may keep the patient alive but not actually make him well. It's far from clear that banks plan to use their cheap and profitable liquidity to boost longer-term lending to the economy. On the contrary, a recent ECB survey suggests credit conditions in the euro zone are still tightening. Draghi says the medication needs longer to take effect. However, a poll

conducted by Goldman Sachs analysts found that just 7 percent of banks plan to use the proceeds of the next LTRO for new loans. By contrast, more than a third expect it to finance purchases of government debt.

The ECB's intervention also raises more fundamental questions. In effect, the central bank has taken the place of the interbank market. Huge deposits parked with the ECB each night are a reminder that those banks with spare cash are too scared to lend it. Meanwhile, troubled lenders grow ever more dependent on central bank funding.

In effect, the system of private sector credit allocation remains seriously distorted. Banks increasingly don't judge loans on the basis of risk and return, but by the ease with which they can be exchanged for cash with the central bank.

Indeed, the ECB last week extended that system by giving seven national central banks permission to accept corporate loans as collateral – a move designed to help smaller lenders which were otherwise at risk of running out of eligible assets.

As a result, the ECB has a say about the financing of an ever-growing chunk of the euro zone economy. Since 2007 its balance sheet has doubled to more than 2.5 trillion euros, according to RBC Capital Markets – over a quarter of euro zone GDP. The next LTRO will lift that proportion further.

Draghi is aware of the dangers of large-scale bank support. He hopes that the ECB will be able to withdraw its medication as confidence returns. This has been done before: during 2008, the Bank of England offered UK lenders three-year loans which had to be repaid or refinanced as they matured. This has been achieved. But Britain has the advantage of having been spared a sovereign debt crisis. And the Bank of England simultaneously pushed the country's banks to build extra capital buffers. The euro zone's fragmented regulators may prove less steely.

Addiction to cheap money may prompt Europe's banks to postpone measures required to improve their health, such as issuing longer-dated unsecured debt. They may also struggle to resist the temptation to use recovering earnings as an excuse to pay higher bonuses and bigger dividends.

But unless borrowers share in the benefits of easier credit, public anger with banks is only likely to grow. Taxpayers may ultimately ask whether an industry that is largely dependent on central bank support should be in the private sector at all. In that event, Dr Draghi's intervention, while a resounding short-term success, may ultimately do more harm than good.

Published 13 February 2012

FANCY FOOTWORK

BY NEIL UNMACK

The European Central Bank will avoid losses on Greek bonds through a legal manoeuvre. Such special treatment will not please the private bondholders who are being asked to take losses on their Greek debt. It might also bring the ECB's bond-buying programme to an end.

The programme was divisive from the start, angering those – mostly German central bankers – who saw it as breaching the principle that the ECB shouldn't help finance budget deficits. The second Greek bailout, based on a 200 billion euro debt swap, has introduced a new controversy: would the ECB take losses alongside private creditors – thus de facto handing out money to Greece – or get paid back in full, thus angering the other bondholders, coerced into accepting to take losses?

The ECB is trying for the middle ground, but it won't please everyone. The central-bank owned Greek bonds will be exchanged for new ones that won't be legally included in the restructuring. So the ECB will be repaid in full. But it then stands to make a profit out of the debt crisis – which would look like a provocation. So the idea is that the bank would over time give those profits back to its shareholders – the euro zone governments. They then could in turn use the money to refinance Greece.

Greece's Prime Minister Lucas Papademos delivers his speech during a conference in Athens. 20/04/2012 Reuters|John Kolesidis

But the fact will remain that private creditors were forced to take losses while the ECB wasn't. In that context future bond purchases will be self-defeating. The more bonds bought by the ECB, the greater the share of debt deemed untouchable, the greater the risks borne by the other creditors, and the higher the yields could be pushed as the proportion of private sector bondholders shrinks further.

Yet this may not ultimately matter too much. The ECB now owns about 219 billion euros of peripheral bonds, of which up to 100 billion are estimated to be Italian bonds – only 5 percent of that country's outstanding public debt. The programme may have been rendered obsolete by the ECB's other crisis-fighting tool – long-term ultra-cheap bank loans injections - which has proved more effective in fighting contagion. But it still means that one of the tools in the ECB's crisis box has been blunted.

Published 17 February 2012

FOUR-LETTER BAILOUTS

BY HUGO DIXON

Bailout may not be a four-letter word. But many of the rescue operations mounted to save banks and governments in the past few years have been four-letter acronyms. Think of the TARP and TALF programmes that were used to bail out the U.S. banking system after Lehman Brothers went bust. Or the European Central Bank's LTRO, the longer-term refinancing operation. This has involved lending European banks 1 trillion euros for three years at an extraordinarily low interest rate of 1 percent.

The markets and the banks have jumped for joy in response to all this liquidity being sprayed around. So have Italy and Spain, whose borrowing costs have dropped because their banks have been able to take cheap cash from the ECB and recycle it into their governments' bonds – making a profit on the round trip. But as has been the case with other four-letter bailouts, the LTRO has come in for criticism – most of it a variation on the theme that the way to treat debt junkies isn't to give them another heroin injection.

One problem is that European governments could now feel less pressure to reform their labour laws and do the other painful things that are needed to get their economies fit. Another is that banks may delay actions that are required to let them stand on their own two feet: such as rebuilding their capital buffers and raising their own longer-term funds on the markets.

As if this were not bad enough, undeserving banks will be able to make bumper profits on the back of the ECB's cheap money and, potentially, route them into fat compensation packages – although two British banks, Barclays and HSBC, have said they won't allow bonuses to be inflated in this way. Meanwhile, the ECB could incur losses if the commercial banks that have borrowed all this money can't pay it back and the collateral they have pledged turns out to be insufficiently valuable. Oh, and don't

forget that this is just a three-year operation. There could be another crisis when the banks need to find 1 trillion euros to repay the ECB in 2015.

The charge sheet is a long one. But the LTRO was a necessary evil. Just think back to early December when panic was stalking the euro zone. Without some form of bailout, there would have been a severe credit crunch that would have dragged the economy into a deep recession rather than the mild one it now seems likely to suffer. Large countries such as Italy and Spain could also have easily been shut out of the markets, potentially leading to a break-up of the single currency.

The ECB faced a too-big-to-fail problem. If it didn't bail out the system, it would be faced with catastrophe; if it did, it would reward foolish behaviour. One can argue with the details. Did the money, for example, really need to be so cheap? But the central bank made a rational choice. The priority now is to limit the bad side-effects.

Mario Draghi, the ECB president, has made a start by telling European Union leaders at their summit last week that the three-year cash injection would not be repeated, according to Reuters. He said it had merely bought the euro zone time and it was essential that structural reforms were pushed through.

Hopefully, such lectures will be sufficient to do the job. But countries rarely reform unless their backs are to the wall. Take Italy. Mario Monti has made a remarkable start pushing through pension changes and liberalising services since taking over from Silvio Berlusconi. But there is much left to do: freeing up the labour market, privatising assets, revamping public spending and fighting tax evasion. How easy will he find it to push all that through now that Italy's 10-year borrowing costs are below 5 percent?

Similar points can be made about Spain, where Mariano Rajoy's reform programme has only just begun. Meanwhile, France, which has so far largely escaped the crisis, will not be under pressure to address its deep-seated labour market and pension problems. Francois Hollande, the socialist who will probably be the country's next president, certainly has no ideological desire to do so.

But won't the new European fiscal treaty deal with the issue? Sadly not. The demand for fiscal austerity was, indeed, the quid pro quo for the ECB's bailout. But it was the wrong sort of conditionality. Balancing budgets is not the same as structural reform. The only thing pushing Europe's governments down the latter route is exhortation and the warning that there won't be any more bailouts.

With the banks, more tools are available to mitigate the damage from the LTRO. After all, governments, the ECB and regulators can tell lenders what to do. The most important changes - requiring them to build stronger capital bases and rely less on short-term funding – are already under way. The key thing will be to resist lobbying to delay and dilute these rules.

A puppet of Italian PM Monti hangs from a stand as workers from Fiom protest in Rome. 09/03/2012 REUTERS/Max Rossi

But there is also a case for revisiting the industry's lax tax regime, especially if compensation remains high. Politicians have given most of their attention to taxing financial transactions, the so-called Tobin tax. But a better alternative could be to introduce what is known as a financial activities tax or FAT tax. Most countries do not apply VAT to banking. FAT, which would tax profits and compensation, would do a similar job. A three-letter tax could be part of the answer to a four-letter bailout.

Published 05 March 2012

LATIN FLIP

BY HUGO DIXON

Spain is replacing Italy as the euro zone's bad boy. Since August, when markets started to seriously worry about Silvio Berlusconi's inability to govern, Italy has been seen as the big troubled euro economy, with higher yields than Spain. At one point in December, Rome's 10-year bond yielded 1.94 percentage points more than Madrid's. But Italy's borrowing costs are now a touch tighter than Spain's. Economics and politics are responsible for the flip.

New prime ministers Mariano Rajoy and Mario Monti have both embraced reform to boost the competitiveness of their economies and rein in deficits. But Monti – who benefits from the added credibility of being a well-respected international technocrat – is seen to have done so more vigorously. Admittedly, Italy has yet to tackle labour reform, an area that Spain has addressed. But Madrid has made much less progress on

REUTERS

shrinking its fiscal deficit, which was 8.5 percent last year, compared to Italy's 3.9 percent, in particular grappling with its overspending regions.

Last week Rajoy said he would cut the deficit to 5.8 percent this year, missing a 4.4 percent target that the previous government had agreed with the euro zone. Madrid has also only started the process of cleaning up its banks.

Meanwhile, Spain's fundamental economic problems remain worse. Its unemployment rate is 23.3 percent, versus Italy's 9.2 percent. Italy may have suffered years of low growth but it has a stronger industrial base.

The one big economic blot on Italy's record is government debt, which was 120 percent of GDP last year, while Spain's was a modest 68 percent. But the Italian private sector is wealthier than its Spanish counterpart – and less indebted.

All these factors mean that Rome's yield advantage over Madrid should continue to widen in the coming months. But in the longer term, the picture gets murkier. After all, Monti is only scheduled to stay in office for another year. As his departure date nears, investors may conclude that a Rajoy in the hand has some advantages over an unknown Italian leader in the bush – particularly if the Spanish leader takes steps to make sure he doesn't fall too far behind.

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F IS FOR FATIGUE
BY HUGO DIXON

Beware the "F" word. The European Central Bank and, to a lesser extent, the zone's political leaders have bought the time needed to resolve the euro crisis. But there are signs of fatigue. A renewed sense of danger may be needed to spur politicians to address underlying problems. It would be far better if they got ahead of the curve.
The big time-buying exercise was the ECB's injection of 1 trillion euros of super-cheap three-year money into the region's banks. A smaller breathing space was won last week when governments agreed to expand the ceiling on the region's bailout funds from 500 to 700 billion euros.

These moves have taken the heat out of the crisis - both by easing fears that banks could go bust and by making it easier for troubled governments, especially Italy's and Spain's, to fund themselves. Data from the ECB last week shows how much of the easy money has been recycled from banks into government bonds. In February, Italian lenders increased their purchases of euro zone government bonds by a record 23 billion euros. Spanish banks, meanwhile, increased their purchases by 15.7 billion euros following a record 23 billion euro spending spree in January.

The risk is that, as the short-term funding pressure comes off, governments' determination to push through unpopular reforms will flag. If that happens, the time that has been bought will be wasted - and, when crisis rears its ugly head again, the authorities won't have the tools to fight it.

Early signs of such fatigue are emerging. One is the tendency of politicians - most recently, Italian Prime Minister Mario Monti - to say that the worst of the crisis is over. They may wish to take credit for their crisis-fighting skills or relax. But it is too early to declare victory.

Italy is a case in point. Monti should have pushed through crucial reforms to the labour market earlier, while his popularity was high and the electorate was afraid that Italy would be engulfed by the crisis. He did not. And although he has now come up with a good package, his honeymoon period as the unassailable technocratic prime minister is nearing its end. His popularity fell to 44 percent from 62 percent in early March, according to a poll published last week by ISPO. Two-thirds of Italians oppose his labour reforms.

A worker from Italy's radical metalworkers union Fiom holds up a flare during a strike in Rome.
09/03/2012
REUTERS/Max Rossi

It's a similar story in Spain. Mariano Rajoy, the incoming prime minister, should have cracked on earlier with a budget to bring the government's finances into balance. To be fair, his administration did publish plans last Friday to curb its deficit - though it won't be possible to judge how credible these are until Madrid explains how the health and

education spending of Spain's free-wheeling regional governments is to be reined in. Meanwhile, Rajoy's honeymoon is also over. Last week, he failed to win the regional election in Andalucia and faced his first general strike.

Both Monti and Rajoy are still in strong positions. Although Italy's political parties could theoretically kick Monti out, they are even less popular than him. Meanwhile, the Spanish prime minister has a sound majority in parliament. But as each month passes, it will get harder to push through reforms. Both men must hold their nerve and implement their full programmes while they can, without compromise.

Further afield, the appetite for austerity is also flagging - sometimes in unexpected places. The Dutch government, one of the high priests of fiscal rectitude, is finding it difficult to cut its own deficit. The ruling coalition may even collapse under the strain. There is also increasing unhappiness about the fiscal discipline treaty Germany rammed through in December. Francois Hollande, the French socialist who is the front-runner to be France's next president, wants to add a growth component to it. So do Germany's social democrats, whose support is needed to ratify the treaty even though they are in opposition.

A fudge will probably be found that adds a protocol to the treaty which emphasises the importance of growth as well as discipline. Indeed, that would be no bad thing: too much austerity can be self-defeating as severe budget squeezes can crush an economy and make it even harder to raise taxes and cut deficits.

However, governments can't ease up on short-term austerity and do nothing. What is needed is a vigorous programme of long-term structural reforms such as freeing up labour markets and introducing more competition into services industries. This could ultimately boost GDP by about 15 percent in large euro countries such as France, Italy and Spain, according to the Organisation for Economic Cooperation and Development. Even Germany, whose services markets are sclerotic, could benefit by about 13 percent of GDP.

Such a programme would make the euro zone's economies fit enough to stand on their own feet when the anaesthetic of cheap money fades. But do governments have the will to make these changes given that the cheap money is lulling them and their people into believing the worst of the crisis is over?

A prod from the markets may be what is required. There are indications that this is beginning to happen. Spanish 10-year bond yields briefly reached 5.5 percent last week. The art, though, will be in the calibration. If markets move too little the politicians will be complacent. If there is too much, the euro zone will slip back into full-blown crisis.

Published 02 April 2012

CHAPTER 7
SPANIC ATTACK

Early May witnessed big changes in Europe's political landscape. Francois Hollande became the first socialist to win a French election since the 1980s. His campaign centred on growth, an implicit challenge to Merkel's focus on austerity and reform. A few days later Italy's municipal elections brought big gains for the eurosceptic Five Stars Movement led by comedian Beppe Grillo.

But, in the short run, the most dramatic development was a Greek election which saw the far-left anti-bailout Syriza party take second position from almost nowhere. The people gave a decisive thumbs-down to the two traditional ruling parties which were no longer able to form a coalition. A second election therefore had to be called for June.

What would happen if Syriza won the next ballot? The political crisis in Athens spawned yet more speculation about a "Grexit" – or Greek exit from the single currency. That, in turn, triggered more capital flight in Greece and other peripheral economies.

France's President Hollande and German Chancellor Merkel smile after kissing each other during a 50th anniversary ceremony in Reims. 09/07/2012
REUTERS/Jacky Naegelen

Spain was now firmly in the firing line, as the botched half bailouts of its banking system came back to haunt it. The government was in May forced to nationalise Bankia, the country's largest mortgage lender. But it couldn't spell out where it was going to find the money. So a few weeks later, Madrid had to appeal to its euro zone partners for 100 billion euros to shore up both Bankia and other weak lenders. But that didn't reassure investors as it just added to Spain's debts.

Meanwhile, the Greeks held their second election. The people were so afraid of a Grexit that they voted narrowly for the pro-bailout New Democracy Party which was then able to form a coalition.

But there was no rejoicing. The Spanish and Italian economies were shrinking and their bond yields were near unsustainable levels. Euro zone leaders, therefore, came up with a new plan to reinforce the single currency in a June summit. They agreed to establish a single supervisor for their banks, hoping this would be the first step in a banking union which, in turn, would be one of the building blocks for a political and fiscal union.

Spain and Italy were initially elated. But, as so often, the summit did not live up to its promise. By the end of July, their bond yields were rising again. The panic was particularly acute in Spain until Draghi said the ECB would do whatever it takes to preserve the euro. Did this represent a genuine turning point in the crisis or just another false dawn?

AUSTERISSIMO
BY PIERRE BRIANÇON

The 200 billion euro-plus poker game between Greece and the rest of the euro zone could fast degenerate into a chain reaction which none of the players could control. Greece seems to be heading towards new elections that would be held mid-June. The way political parties describe what's at stake will pave the way for the ultimate outcome - either some form of compromise on the austerity plan, or a catastrophic euro zone exit.

For the moment, Greece's public sector lenders don't need to tighten the screw by withholding the payments agreed in the latest bailout package. There's still a temporary government in Athens, and no official request has been made to amend the terms of the bailout.

But assume a government can be formed after the June election - already a generous assumption. The tough talk heard these days in Berlin and Brussels on the need for Greece to comply with the plan shouldn't be taken at face value. The authorities there, and at the International Monetary Fund don't want to make the Greek crisis worse. A lot depends on whether François Hollande, the new French president, can suggest a face-saving compromise between Germany's rigid stance and Greece's chaotic demands. This will be his first opportunity to flesh out his demands for a greater emphasis on growth within the euro zone.

But if no agreement is found, and if Greece then reneges on its pledges to implement the bailout plan, the sequence of events could unfold fast. Payments to Greece are suspended, Athens defaults on debts to public creditors, the bank run accelerates, and the ECB turns down Greek banks' collateral.

The country then finds itself de facto outside the euro - without any formal declaration or decision. It can't pay for its imports, a painful predicament considering the massive current account deficit (projected at 7.4 percent of GDP this year). What happens then is anyone's guess.

Greek political leaders would like to have the euro without austerity. If they fail to turn the upcoming campaign into a clear-choice referendum on what the monetary union means, they will have austerity without the euro.

Published 10 May 2012

POKER FACE
BY HUGO DIXON AND FIONA MAHARG-BRAVO

Madrid will regret refusing a front-door bailout. The straightforward way of dealing with Spain's banking problem would be for the government to borrow 50 to 100 billion euros from the European Financial Stability Facility (EFSF) or the soon-to-be-created European Stability Mechanism (ESM), and inject that money into the banks. But Mariano

REUTERS

Rajoy, the country's prime minister, continues to deny publicly that the country needs such a rescue.

There are probably two reasons. First, Madrid is worried about the consequences of following Greece, Ireland and Portugal down the bailout road. Not only would there be stigma, which could shut Spain out of the bond markets and force it to seek more extensive help from its euro zone partners; the government might have to agree to further reforms on top of everything it is already doing to tighten up its finances and free up the labour market.

Demonstrators wearing masks depicting Rajoy, Merkel, Monti and Hollande pose as they simulate playing a soccer match to protest against the euro zone debt crisis, in Rome. 22/06/2012
Reuters|STRINGER Italy

The second reason is that Rajoy clings to hopes that there are back-door ways to rescue the country. To help the government, ECB could relaunch its programme of buying sovereign bonds. Provided it is done on a scale large enough to impress markets, it could push Spanish yields down from the current, punitive 6.7 percent. It could be done quickly - but the ECB is clearly reluctant.

To help the banks, Madrid's favourite idea is to get the EFSF or the ESM to inject capital directly into its lenders. That would shore them up without the government's own debt rising. The snag is that this would require an overhaul of the funds' mission - and Germany is against the idea. Madrid therefore has floated the idea of injecting 19 billion

euros of bonds into BFA-Bankia, the largest problem bank. BFA-Bankia would then swap those bonds with the ECB for cash. But the central bank doesn't want to be seen as financing government deficits in such an overt manner.

Germany and the ECB may come to relent. But that may require a further worsening of the crisis, and a scenario where Greece would leave the euro. At that point, Spain could face a deposit run and Italy could also be in trouble. At the moment, there isn't enough money in the bailout funds to rescue both countries. Rajoy should grab the money to shore up his banks while he can.

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HOMERIC DILEMMA
BY HUGO DIXON

Odysseus would recognise the dilemma faced by today's Greeks as they must choose either the pain of sticking with the euro or the chaos of bringing back the drachma. The Homeric hero had to steer his ship between the six-headed sea monster, Scylla, and the whirlpool, Charybdis. Avoiding both was impossible. Odysseus chose the sea monster, each of whose heads gobbled up a member of his crew. He judged it was not as bad as having the whole ship sucked into the whirlpool.

As Greece heads to the polls on June 17 for the second time in just over a month, none of the options it faces are attractive. The economy has shrunk about 15 percent from its 2008 peak, unemployment stands at 22 percent and further austerity and reform are required as part of the euro zone/IMF bailout. But the lesser of two evils is staying the course.

Some of this misery was inevitable. Greece's current account and fiscal deficits each reached around 15 percent of GDP in 2008 and 2009, and had to be cut. But successive Greek governments have managed to make the situation worse than it needed to be.

When Odysseus had to pass by the sea monster, he told his crew to row as fast as possible and not stop. That way, each of Scylla's heads only had time to munch one man.

By contrast, today's Greeks have dawdled. Confidence in the country and its political class is shot to bits, both at home and abroad. Capital is fleeing, investment has vanished and tax-dodging has become even worse than it was - which is saying a lot. The government isn't paying its bills, nor are many companies. As a result, Scylla keeps gobbling up more men.

Terrible as things are, the current situation is not hopeless. The budget deficit, before interest payments, declined by 9 percentage points of GDP in 2010-2011. The economy is also getting more competitive: unit labour costs, which shot up vis-a-vis Greece's euro zone partners in the first decade of the single currency, had by the end of last year

recouped half the lost ground. They will have fallen further since the minimum wage was slashed earlier this year.

What is now needed is a strong government. It should embark on three main tasks. First, continue the reform programme, and get serious at last on fighting tax evasion. Second, negotiate with the euro zone/IMF a longer period to eliminate its budget deficit and secure investment to boost short-term growth. Third, negotiate another debt reduction plan.

If such a government were formed, confidence could gradually return and the economy could stop shrinking. The experience of the Baltic countries - Latvia, Lithuania and Estonia - shows such reforms can work. After the credit crunch crisis, GDP in the three countries fell by between 15 and 21 percent but has since partly recovered.

Head of radical left SYRIZA party Tsipras addresses parliamentarians during a session at the parliament in Athens. 07/07/2012
REUTERS/Yorgos Karahalis

But wouldn't going back to the drachma be better? Some commentators point to countries like Iceland, which restored its competitiveness by a massive devaluation following the credit crunch and only suffered an 11 percent fall in GDP. Wouldn't devaluation be a quicker and less painful way for Greece to get back in shape?

The answer is no - for two reasons. First, the dislocation caused by bringing in a new currency would be much more severe than devaluing a currency that already exists. The banks would temporarily run out of cash and there would be multiple legal disputes over who owes what, which could gum up the economy for years.

Second, Greece is receiving an extraordinary amount of cheap money as part of its second bailout plan: 130 billion euros, or 88 percent of GDP. This gives it time to cut its twin deficits. If Athens left the euro, it would be lucky to get a fraction of that cash. The country would then have to balance its books immediately.

An even harsher fiscal squeeze would exacerbate the vicious spiral. The alternative would be to print drachmas to fill the hole in the budget. But such monetary financing would lead to rapidly rising inflation, which would already have been given a boost by the devaluation. Lucas Papademos, the country's former technocratic prime minister, predicted last week that inflation could reach 30-50 percent in such a scenario.

Meanwhile, Greece is hugely dependent on imports not just for final consumption but also to keep its economy going. It imports oil, medicine, food. If it had to slash imports suddenly, industry would grind to a halt. Even tourism, the mainstay of its economy, which accounts for 16.5 percent of GDP, could suffer if hotels promising a five-star experience delivered a three-star one. GDP might fall another 20 percent, according to Papademos.

Social unrest would worsen, with street battles, attacks on immigrants, vigilante law enforcement and major strikes. That would further deter the tourists. It would also make it harder to put together a sensible government. The field would be open for populists and extremists. This way leads to Charybdis.

To avoid this menace, the electorate will need to give a strong leader the mandate to pursue the current course more vigorously. Unfortunately, neither of the front runners in next Sunday's election - conservative Antonis Samaras and radical leftist Alexis Tsipras - is a modern-day Odysseus. And neither looks able to secure a decisive win. Unless a third election can produce a better outcome, the drachma will probably return, and the Greeks will get sucked into the whirlpool.

Published 11 June 2012

DON'T BANK ON IT
BY HUGO DIXON

Some European policymakers are talking about a "banking union" for the euro zone as if it was around the corner. Jose Manuel Barroso, the European Commission president, for example, told the Financial Times last week that such a union - which would involve euro-wide supervision, bailouts and deposit insurance for the banking industry - could be achieved next year.

But this is not remotely likely. Parts of the zone's banking industry are so rotten that taxpayers elsewhere can't reasonably be asked to bear the burden of bailing them out. A massive cleanup is required first. The crisis in Greece, Spain and other countries may

provide the impetus. But even then, as Germany suggests, banking union should proceed in stages.

The appeal of a euro zone banking union is understandable. Governments and lenders are currently roped together in what has been dubbed the sovereign-bank doom loop. Weak banks - for example those in Spain, Ireland and Cyprus - can drag down their governments when they need a bailout. Equally, weak governments, such as Greece's, can drag down their banks when those are stuffed with their own sovereigns' bonds. By shifting responsibility for bailouts to the euro zone as a whole, the loop could be cut. Or, at least, that is the hope.

The snag is that banks and their governments are entangled in a tight incestuous relationship. Some of Spain's cajas, for example, made dubious loans to their directors, as well as financing politicians' pet projects. And the ex-chairman of Bankia, which has required the mother of all bailouts, was a former finance minister. Conflicts of interest have also been rife in Ireland, Cyprus and Greece. Even supposedly virtuous Germany has suffered from incompetent Landesbanken, controlled by regional governments, whose boards are filled with political appointees.

Bank boards were often useless or worse. But the national supervisors who should have spotted the problems were not much better. And Europe's initial attempts at cross-border banking supervision have been pathetic. A European-wide stress test in 2010 didn't even bother to examine Anglo Irish, a cesspit of bad property loans which virtually bankrupted Dublin. Another test in July 2011 concluded that Spain's banks were only 1.6 billion euros short of capital. Then another last October bumped the number up to 26 billion euros - but didn't stress the lenders' property loans. Finally, last weekend's bailout came up with a hopefully more realistic figure: up to 100 billion euros.

Governments have given the European Banking Authority (EBA) inadequate authority to overrule national supervisors. Meanwhile, the domestic authorities always have an incentive to downplay the capital needs of their banks. So long as lenders are pronounced solvent, they can get liquidity from the European Central Bank. That way, governments can delay putting in any of their own money to bail out their domestic lenders.

Part of the "doom loop" involves banks stocking up on sovereign debt. That link has grown tighter in Italy and Spain in recent months as foreigners have stopped buying bonds, leaving domestic lenders to step into the breach. They got the money from the ECB. If governments really surrendered control of their banks to a tough supranational agency, it would be harder to engineer such a money-go-round.

Yet another problem is that governments are reluctant to inflict losses on bondholders. In Bankia's case, there were an estimated 12 billion euros of subordinated debt and 8 billion euros of senior debt - or 20 billion euros in total. These have not suffered losses as part of the bailout. But unless there are haircuts for a bank's own bondholders, is it reasonable to ask the taxpayers of a foreign country to fork out cash to bail out banks and their depositors?

All this means that for banking union to work effectively, there needs to be effective supervision as well as a system to bail in bondholders. Everyone agrees on this. The real debate is largely one of timing. The peripheral countries want a euro-wide system of bailouts and deposit insurance fast, as an answer to the current crisis. Germany is stressing the need to start with supervision.

File photo of president of Spanish bank Bankia Rato during a news conference in Madrid. 07/05/2012 Reuters | Andrea Comas

Berlin is right that the clean-up has to come first. That may, of course, be accelerated by the crisis. Spain's banking bailout gives the rest of the euro zone a golden opportunity to insist that its system of crony finance is swept away. The same goes for Cyprus, a haven for recycling dubious money from Russia and elsewhere, if it requires a bailout.

But the euro zone will also need to determine who will supervise banks. The EBA is a busted flush. So it would be best way to empower an institution that has credibility. The obvious candidate is the ECB - an idea Germany's Angela Merkel backed last week. But even that could be problematic: giving the ECB responsibility for supervision as well as monetary policy would concentrate a huge amount of power in a single body. Even it might struggle to monitor banks over such a vast area.

Then, of course, a system for bailing in bondholders needs to be crafted. Although the European Commission this month proposed a plan, it is not supposed to kick in until 2018. Finally, there is the question of how governments in trouble will finance their debts if they can no longer lean on their banks. Nobody yet has a good answer to this.

The banking union train may be about to leave the station. But it will take years to reach its destination.

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TRAGICOMEDY
BY HUGO DIXON

Mario Monti is pinned between two comedians. Beppe Grillo, a professional comic and leader of Italy's so-called second force, wants the country to quit the euro and default on its debts. Silvio Berlusconi is also toying with euroscepticism as he attempts a comeback. This makes it much harder for a technocrat prime minister to manage the crisis.

The phenomenal rise of Grillo's Cinque Stelle movement has shaken up the political landscape. In two months, its support has shot up from 7 percent to 20 percent, according to SWG, the pollster. Grillo has benefited from disgust with the ruling class, in much the same way as Alexis Tsipras, the radical leftwing politician who almost won Greece's last election. The Italian comic's anti-politician message, which initially appealed mainly to people on the left, is now striking chords on the populist right.

Berlusconi's centre-right PDL, which is supposed to be backing Monti, has been the principal victim of Grillo's rise. Its support has declined from 25 to 17 percent. The former prime minister has therefore himself started suggesting that either Germany should quit the euro or Italy should bring back the lira.

If Monti had his own party, these shifts in popular mood might not matter too much. But he doesn't. What's more, an election must be held by next spring and there are even fears that Berlusconi may force an early one in the autumn.

Monti, who has lost momentum after a strong start as prime minister, may yet find a way of pushing through a second wave of reforms. But confidence in him has collapsed, from 71 percent when he took over from Berlusconi in November to only 33 percent now. Although he is backed by the centre-left PD, the country's most popular party, he risks becoming a lame duck.

The concern is that euroscepticism from Italy's second and third political forces could create a negative feedback loop. Investors could push up bond yields as they worry about what comes after Monti - further undermining confidence, exacerbating the recession and sowing more doubts about the euro's survivability.

Published 25 June 2012

Italian comic and political activist Grillo dumps rotten mussel shells in front of the Parliament in Rome.
10/09/2011
REUTERS/Alessia Pierdomenico

DINOSAUR STILL THERE

BY HUGO DIXON

Cuando despertó, el dinosaurio todavía estaba allí. "Upon waking, the dinosaur was still there."

This extremely short story by Guatemalan writer Augusto Monterroso sums up the state of play on the euro crisis. Last week's summit took important steps to stop the immediate panic. But the big economies of Italy and Spain are shrinking and there is no agreed long-term vision for the zone. In other words, the crisis is still there.

The summit's decisions are not to be sniffed at. The agreement that the euro zone's bailout fund should, in time, be able to recapitalise banks directly rather than via national governments will help break the so-called doom loop binding troubled lenders and troubled governments. That is a shot in the arm for both Spain and Ireland. Meanwhile, unleashing the bailout fund to stabilise sovereign bond markets could stop Rome's and Madrid's bond yields rising to unsustainable levels.

REUTERS

Insofar as this restores investors' confidence, Spain and Italy could avoid the need to obtain a full bailout or restructure their debts. And Ireland, which is in a full bailout programme, could exit that and fund itself in the market again.

The immediate market reaction on Friday was positive. The yield on 10-year bonds fell: for Spain from 6.9 percent to 6.3 percent, for Italy from 6.2 percent to 5.8 percent and for Ireland from 7.1 percent to 6.4 percent. But these rates are still high. And, with the exception of Ireland, Friday's market movements only take prices back to where they were in May.

What's more, as the details of Friday's agreement are picked over, some of the market euphoria may well fade. After all, Germany, the zone's paymaster, hasn't written a blank cheque.

Take the bank recapitalisation plan. Madrid is planning to inject up to 100 billion euros into its banks and Dublin has already sunk 64 billion euros into its lenders. The big question is whether the euro zone will reimburse them the full amount invested, given that the stakes in the banks aren't worth as much. That seems unlikely. But if the full sum isn't paid, the debt relief for Spain and Ireland may not be as big as some are hoping.

Or look at the market stabilisation mechanism. The euro zone bailout fund's resources are limited, so it might not be able to keep Italian and Spanish borrowing costs down in the long run. What's more, to access this mechanism, a country would have to agree to a memorandum of understanding setting out its policy commitments to reform its economy. This means that there will still be some stigma attached to the scheme - which probably explains why Rome and Madrid aren't rushing to sign up.

To point out that Germany's Angela Merkel hasn't agreed a blank cheque is not to criticise the summit compromise. It is essential that Italy's Mario Monti and Spain's Mariano Rajoy take further measures to restore their countries' competitiveness. A second wave of reforms is needed, but both prime ministers have lost momentum in recent months. Money for nothing will take away pressure to do more.

However, the continued uncertainty about exactly how bank bailouts and market stabilisation will work means that the summit did not produce a neat package. As the loose ends are tied up, there could be further wrangling that unnerves investors.

Meanwhile, GDP in both Italy and Spain are continuing to shrink. This means that they won't hit their deficit reduction targets and that their debts and unemployment will rise further. The summit's 120 billion euro growth pact isn't likely to move the needle. More may need to be done to shore up growth. One obvious suggestion would be still looser monetary policy from the European Central Bank.

Recession also has political consequences, especially in Italy, where elections are due next spring at the latest. Both Beppe Grillo, a comedian whose populist Cinque Stelle movement has come from virtually nowhere to 20 percent in the opinion polls in recent months, and Silvio Berlusconi, the former prime minister, are playing the eurosceptic

card. In the circumstances, Monti's technocratic government will struggle to gain political support for any more reforms. Investors and Italy's euro partners will, in turn, worry about what comes after him.

The euro zone leaders also agreed, in principle, on the first step towards a long-term vision for the region: the creation of a single banking supervisor "involving the ECB". If this cleans up the mess in large parts of the European financial system, it will be good. But some countries will not wish to surrender control over their banks to a centralised authority and so it is quite possible that some messy fudge will emerge.

If the question of a single banking supervisor is likely to be subject to future disputes, even more disagreement can be expected over whether there should be a full political and fiscal union. Some countries like Germany want much more common decision making, but others fear the loss of sovereignty. Meanwhile, many weaker nations want to pool their debts - an idea rightly rejected by Merkel.

Europe's people are not ready for full political union. So the best solution would be to keep the loss of sovereignty and debt-sharing down to the minimum. But the summit kicked these big issues into touch.

The dinosaur is less terrifying than it was a few weeks ago. But it is still there.

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SPANIC STATIONS

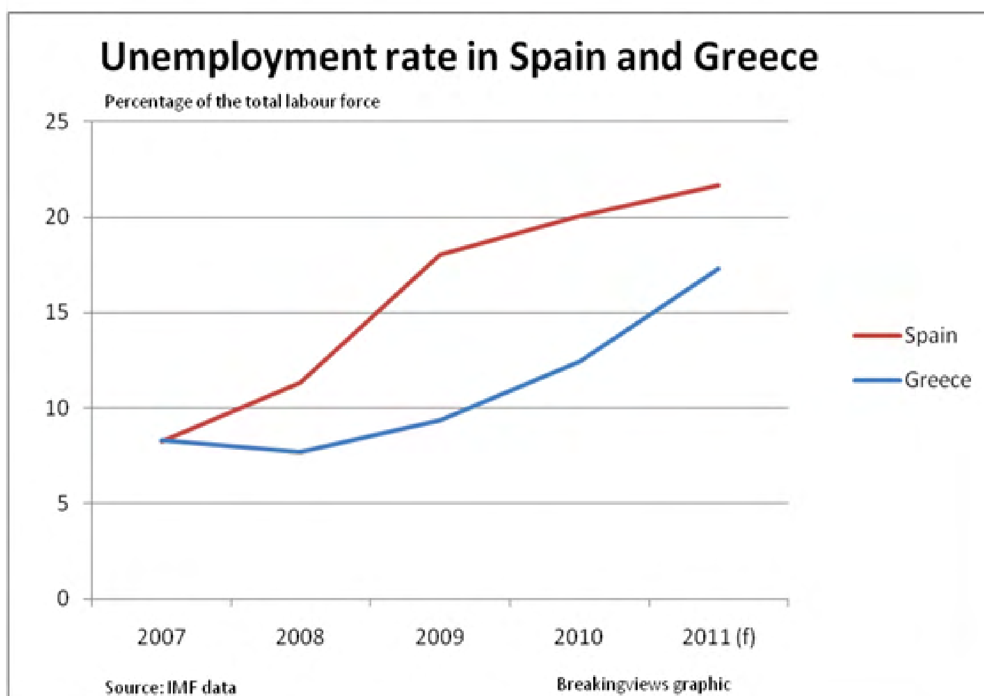
BY HUGO DIXON AND FIONA MAHARG-BRAVO

Capital flight will determine the course of what traders are calling the Spanic - or Spanish panic. Madrid can withstand the market mayhem until October when big bond repayments are due, provided the turmoil doesn't spill over into the banking system. But if capital flight accelerates, policymakers across Europe will have to break their holidays and concoct a rescue. The politics won't be easy.

Investors are now actively discussing not just the likelihood that Spain will need a full bailout but also that the country's debt will be restructured. Hence, Madrid's borrowing costs are soaring - especially at short maturities.

The dramatic shift in sentiment over recent days has multiple causes. Top of the list is the realisation that last month's euro zone summit didn't provide an easy way for Spain to shift the 100 billion euro cost of recapitalising its banks onto its euro partners. Germany insists that the liability for the "bank only" bailout is with Madrid. It is also clear that Berlin is keeping its options open over whether Spain could shunt the liability to the euro zone's bailout fund even after a centralised bank supervision mechanism for the region is agreed, a condition spelt out at the summit.

Then there's timing. Germany and the other core countries may eventually agree to take on the burden of recapitalising Spanish banks. But even if they do, it could be over a year away - perhaps conveniently after next year's German general elections. The creditors will also demand a pound of flesh. Berlin has spoken of the need for Madrid to guarantee any capital injections by the European Stabilisation Mechanism, the new piggy bank. That would hardly reassure Spain's investors, even if such an indemnity didn't officially sit on the national balance sheet.



Now add in renewed doubts about how Spain's indebted regional governments will fund themselves. Compounding it all, German politicians have again been raising the possibility that aid to Greece might be cut off. This had a knock-on effect on Spain and Italy, refocusing investors' attention on the fact that there isn't enough money in the bailout funds to rescue both countries. What's more, the ESM won't even exist until and unless the German constitutional court gives its approval in September.

So what's to be done? That will be the topic when Luis de Guindos, Spain's finance minister, meets his opposite number Wolfgang Schaeuble this evening in Berlin. Neither side wants a full bailout. The Spanish could do without the extra conditions. And with Spain's bank rescue only recently approved, a rescue three times the size would be a tough sell for German politicians.

A sticking-plaster solution might be a mini-bailout, for example a bridging loan or direct purchases of Spanish debt by the European Financial Stability Facility, the forerunner to the ESM.

But the inclination will probably be to tough things out over the summer. This may be possible given that Madrid tapped relatively benign markets earlier this year to fund most of its borrowing requirements. The crunch may be postponed until October when around 27 billion euros of bonds come due. By then, the ESM should be up and running and markets may even have calmed down.

But what if the panic spreads? The real danger would be a liquidation of bank deposits. There were signs of this in May and June in response to the anxiety caused by Greece's twin elections. Spaniards feared that, if the drachma came back, so could the peseta. These concerns may now resurface.

If this happened, the European Central Bank would be the first line of defence. Even though it is reluctant to help out Madrid directly, it would feel compelled to provide liquidity to Spanish banks provided they were solvent. Yet many lenders probably won't be solvent until their recapitalisation is complete, which is months away. So in the event of a run, Spain would have to take 30 billion euros of emergency funds set aside in its bank bailout and inject them into the banks to make them eligible for ECB liquidity.

Even if the line can be held until October, the outlook isn't pretty. Any remaining confidence could melt away in the summer heat, driving the economy further into recession. And the really tricky question still lacks an answer: how to rescue Spain if it is shut out of the bond markets in October and Italy gets sucked into the vortex.

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CHAPTER 8
THE WAY FORWARD

Given the magnitude of the euro crisis, wouldn’t it just be better to abandon the single currency? The answer sadly is no. Nobody has yet come up with a method of unscrambling this egg without creating more mayhem.

Is the solution then fully-fledged fiscal and political union? That is the conventional wisdom. But this is neither desirable nor deliverable. People across Europe are just not ready to sign away their sovereignty.

So is there a middle way? One of the articles in this chapter argues that there is. The single currency can be salvaged provided three conditions are met: there are much more flexible markets; the creditors of insolvent banks and governments are forced to take haircuts; and there are adequate lender-of-last-resort mechanisms for solvent lenders and countries.

But there’s still a question of how to get through the immediate crisis. Many of the ideas proposed - such as euro bonds - have already been shot down by Germany or the ECB. But a few haven't and there is a possibility that even some that have will be revived. The main problem is how to assemble a firewall big enough to protect both Italy and Spain.

One idea is for the ECB, which can theoretically create unlimited money, to revive its controversial bond-buying programme and drive down Rome's and Madrid's borrowing costs. Another is to let the euro zone's bailout fund increase its firepower by borrowing from the ECB - although that would require Draghi, who has previously opposed the idea, to eat his words. Yet another is for core governments to make direct interest subsidies to peripheral ones. In any of these cases, Italy and Spain would clearly have to stick to strong reform programmes as a quid pro quo.

So there are solutions. It's just a question of the policymakers rising to the magnitude of the occasion and acting decisively - which, of course, is no trivial matter.

HOTEL CALIFORNIA
BY HUGO DIXON

The euro zone is like Hotel California, UBS wrote in a report published in September. "You can check out any time you like but you can never leave," it said, quoting the Eagles song. A British businessman, Simon Wolfson, has now offered a 250,000 pound prize to the person who can come up with the most convincing explanation of how an orderly exit from the single currency is possible.

The problem is the word "orderly". There are lots of scenarios where a country such as Greece could quit the euro in a disorderly fashion, destroying its own economy and that of its neighbours as well as possibly plunging the world into a recession. But how is it possible to do this without triggering financial Armageddon?

The first difficulty stems from the fact that an exit couldn't happen overnight. There is no legal procedure for a country to quit. Joining was supposed to be an irrevocable commitment.

Treaties can, of course, be renegotiated or broken. But this couldn't happen rapidly – or, more to the point, secretly. There are 17 members of the euro zone; and another 10 European Union members such as the United Kingdom, which don't use the single currency. If Greece wanted to reintroduce the drachma, it would have to secure the unanimous agreement of these other nations. It is also inconceivable that it could take such a momentous decision without discussing it in parliament. Predict weeks, if not months, of heated wrangling.

Such debate would frighten the horses. Many depositors have already removed their savings from Greek banks. An open discussion about Athens leaving the euro would trigger a stampede. The whole point of bringing back the drachma would be to devalue it in the hope of making Greek industry competitive. Analysts think the initial fall might be 50 percent. If so, anybody patriotic enough to keep their money in a Greek bank would lose half their savings.

Transitional mayhem

Athens could then do three things: allow its banks to collapse; appeal to its euro partners for help; or impose controls on how much money people could take out of its banks.

Allowing banks to collapse in a disorderly fashion would be mad. It would be a sure-fire way to cause economic chaos and social disorder. The recent street protests would seem like a tea party.

Getting help from the euro zone would be ideal. But why would its euro partners want to bail out Greece's banks, if the country was on the point of quitting the euro? The European Central Bank has already stopped making new loans directly to some Greek banks because they have run out of high-quality collateral. Instead, it has authorised the

REUTERS

Greek central bank to provide liquidity, with Athens theoretically on the hook for any losses. But if Greece was about to quit the euro, the ECB would be worried that it would never get paid back. It would hardly want to authorise yet more lending as this could just increase the size of its future losses.

So Athens' only choice would be to control how much people could take out of their accounts. It would be like wartime – with savings rationed instead of butter and bread. This wouldn't be as bad as allowing banks to collapse. But it would still plunge the country deeper into misery.

Brave new economy

The hope, of course, would be that Greece would eventually rebound on the back of a super-competitive drachma. Northern Europeans would flock to its beaches to enjoy half-price retsina and feta. Maybe. But there would be two other questions: how would the government finance itself; and how would inflation be contained?

Athens has too much debt. The latest forecast from the Troika (made up of the International Monetary Fund, the ECB and the European Commission) is that debt will reach 183 percent of GDP by the end of next year. That debt load will loom even bigger if Greece quit the euro. In drachma terms, assuming again a 50 percent devaluation, debt would rocket to 366 percent of GDP. The government has to default even if it stays in the euro; but the extent of the haircut would be bigger if it quits.

Greece also has a primary budget deficit: it is earning less than it spends even before interest payments. A unilateral default would make it a pariah state. Nobody would lend it money to finance its ongoing deficits. That would provoke an even more severe recession in the short run. The government would also be tempted to print lots of new drachmas to fill the hole in its coffers, fuelling inflation and debasing the currency.

To avoid such a nightmare scenario, Greece would need to secure an orderly default if it quit the euro. The best hope of achieving that would be to cut a new agreement with the IMF. Most but not all of its debts would be cancelled. But it would have to agree to tight fiscal and monetary policies to make sure it didn't run up new debts or descend into hyperinflation. In return, it would get some hard currency to manage the transition. But even with such a balm, the journey would be painful.

Vicious contagion

Unfortunately, the problems with a Greek exit from the euro would not stop with Greece. Contagion would be far more virulent than anything witnessed so far.

Seeing what was happening to Greek depositors, savers in Ireland, Portugal, Spain and Italy – and possibly even France and other countries – would run a mile. They would take their euros and deposit them in German, Dutch or Finnish banks. To stop a large chunk of Europe's banking system collapsing, the ECB would have to authorise unlimited supplies of liquidity for an indefinite period of time.

The key decision would be whether to let any other countries go the way of Greece. Portugal would be seen as next in line because of its need to improve competitiveness. But Lisbon would probably not want to quit. Given that there's no time to waste in the midst of a bank run, the least bad option would be to rally around all the remaining euro countries and insist they were permanent members of the club.

It might, though, be sensible to take the opportunity of a Greek exit from the euro to arrange simultaneously an orderly default of Portugal and perhaps Ireland while keeping them in the single currency. If their debt levels were cut to more sustainable levels, they would be in a better shape to withstand the whirlwind unleashed by Athens' departure.

Wherever the line was drawn, it would have to be defended to the hilt. This wouldn't just be about protecting depositors. Bond investors would believe more departures from the single currency were on their way. Portugal and Ireland don't matter for the time being because they are supported by euro zone and IMF bailout programmes which don't require them to tap the market for new money. But Italy and Spain, which are already suffering jitters, would be shut out of the market.

Protesters observe a minute of silence during protest marking the one year anniversary of Spain's Indignados movement in Madrid. 12/05/2012
Reuters|Andrea Comas

REUTERS

The convulsions from a bankruptcy of Italy, whose debt is nearly 2 trillion euros, would be so seismic that it shouldn't be attempted unless there really is no alternative. But rescues by other governments wouldn't be possible either. The region's bailout fund, the European Financial Stability Facility, isn't remotely big enough.

Financial jiggery-pokery – such as turning the EFSF into an insurance company to leverage its firepower – might just work in the current circumstances. But it wouldn't have credibility if Greece was quitting the euro and there were bank runs across the continent. The best way to hold the line would be for the ECB to provide unlimited supplies of liquidity to struggling nations by massively expanding its purchases of Italian, Spanish and other sovereign bonds in the secondary market.

The good thing about the ECB is that there is theoretically no ceiling on how many euros it can print. The problem is that massive liquidity injections to both banks and governments could remove the incentive for lenders and countries to manage their affairs wisely. Once the storm had passed, it would be best to separate the illiquid institutions or governments from the insolvent ones and find a way of restructuring the debts of the latter in an orderly fashion.

But faced with the choice between an imploding euro zone or underwriting delinquency, the ECB would be best advised at least initially to plump for the latter even if that would involve eating its words. Still, there's no disguising that it would be an unpleasant outcome.

An orderly exit from the euro is a virtual oxymoron. There are ways to minimise the damage – principally by rationing access to savings during the transition, orchestrating an orderly default of the country that quits and unleashing the ECB as a lender of last resort to those that remain. Even with such a programme, the economic damage would be huge. Without it, staying in Hotel California would seem like a holiday. The euro zone would become a towering inferno with everybody scrambling for the exits.

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EURO VISION CONTEST
BY HUGO DIXON

What should be the long-term vision for the euro zone? The standard answer is fully-fledged fiscal, banking and political union. Many euro zone politicians advocate it. So do those on the outside such as David Cameron, Britain's prime minister, who last week called on the zone to "make up or break up".

The crisis has demonstrated that the current system doesn't work. But a headlong dive into a United States of Europe would be bad politics and bad economics. An alternative, more attractive vision is to maintain the maximum degree of national sovereignty consistent with a single currency. This is possible provided there are liquidity backstops

for solvent governments and banks; debt restructuring for insolvent ones; and flexibility for all.

Enthusiasts say greater union won't just prevent future crises - it will help solve the current one. The key proposals are for governments to guarantee each other's bonds through so-called euro zone bonds and to be prepared to bail out each other's banks. In return for the mutual support, each government and all the banks would submit to strong centralised discipline.

But the European people are not remotely ready for such steps. Anti-euro sentiment is on the rise, to judge by strong poll showings by the likes of France's Marine Le Pen and Italy's Beppe Grillo. Germany's insistence last December on a fiscal discipline treaty has stoked that sentiment.

An attempt by the region's elite to force the pace of integration with even more ambitious plans could easily backfire with voters, particularly in northern Europe. They would fear being required to fund permanent bail outs for feckless southerners. Premature integration might not even help with the current crisis if it backfired with investors. They might start to question the creditworthiness of a Germany if it had to shoulder the entire region's debts.

In contrast, the principle of "subsidiarity" - the Maastricht treaty's specification that decisions should be taken at the lowest possible level of government that is competent to handle them – is good politics and good economics. Of course, even advocates of political union such as Wolfgang Schaeuble, Germany's finance minister, subscribe to this principle. The issue is to define the minimum conditions needed for the sustainability of the single currency. There are probably three.

The first is that insolvent entities - whether they are governments or banks - should have their debts restructured. One of the main reasons states and lenders were allowed to leverage themselves so much in the boom was because there was a widespread view that they couldn't go bust. The complacency sowed the seeds of the crisis.

Meanwhile, a key mistake in managing the crisis was the failure to restructure Greece's debts as soon as they became unbearable. If that had been done, private-sector creditors would have taken the hit. Instead, they were largely bailed out - with the result that 74 percent of Athens' outstanding 274 billion euros in debt is now held by governments and the International Monetary Fund, according to UBS. This means taxpayers will be on the hook when the big fat Greek default occurs.

Of course, if Greek debt had been restructured earlier, banks in the rest of the euro zone would have had big holes in their balance sheets. Some would have needed bailouts from their governments. But that would have been better than the current debilitating long drawn out sovereign-cum-banking crises.

What's more, in the future, insolvent banks shouldn't be bailed out either. Their creditors should be required to take losses before taxpayers have to stump up cash. The failure to

do so explains why the government of Ireland, previously financially solid, become infected by its lenders' folly.

The second minimum condition for monetary union to flourish follows the first: there should be liquidity backstops for banks and governments that are solvent.

An one Euro coin is pictured next to the words bankruptcy in an English-German dictionary in Munich. 10/02/2012
Reuters | Michaela Rehle

With banks, the natural liquidity backstop is the European Central Bank. The quid pro quo is that lenders have to be properly capitalised. Time and again throughout the crisis, euro zone governments have ducked this issue. Only this month, France and Germany conspired to dilute the Basel 3 global capital rules as they apply to Europe, while Spain imposed another half-hearted restructuring on its banks. If the euro zone's leaders want a successful single currency, this nonsense has to stop.

For governments, the natural liquidity backstop is the European Stability Mechanism, the zone's soon-to-be-created bailout fund. To do its job properly, it will need extra funds - as it isn't be big enough to help both Spain and Italy. One option could be to allow it to borrow from the ECB.

Again, the quid pro quo would be solvency. Insolvent government would only get access if they restructured their debts. And illiquid but insolvent ones would need credible long-term plans to cut their debts. Italy, with debt over 120 percent of GDP but huge private wealth and state assets, might one day find itself in the latter category. In return for liquidity, it might have to agree a multi-year programme to privatise real estate and to tax wealth.

The final minimum condition for a successful monetary union is much more flexibility, particularly in labour markets. This is the key to restoring competitiveness in southern Europe and enabling the zone to respond to future shocks.

If the euro zone can do these three things - restructure insolvent institutions' debts, provide liquidity to solvent ones and improve flexibility everywhere - nations will be able to keep both the euro and much of their sovereignty. That's a preferable vision to either a euro super-state or the chaos of disintegration.

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MIND THE GAP
BY HUGO DIXON

The break-up of the euro would be a multi-trillion euro catastrophe. An interest subsidy costing around 50 billion euros over seven years could help save it.

The immediate problem is that Spain's and Italy's borrowing costs - 6.3 percent and 5.8 percent respectively for 10-year money - have reached a level where investors are losing confidence in the sustainability of the countries' finances. A vicious spiral - involving capital flight, lack of investment and recession - is under way.

Ideally, this week's euro summit would come up with a solution. The snag is that most of the popular ideas for cutting these countries' borrowing costs have been blocked by Germany, the European Central Bank or both.

Take euro bonds, under which euro zone countries would collectively guarantee each others' debts. They would allow weak countries to borrow more cheaply. But Germany won't stand behind other countries' borrowings unless they agree to a tight fiscal and political union which prevents them racking up excess debts in future. Such a loss of sovereignty France, for one, will find hard to swallow.

Or look at pleas for the ECB to buy Italian and Spanish government bonds in the market. That too would cut their borrowing costs - for a while. But when the bond-buying ends, the yields would just jump up again. Private creditors would merely use the opportunity to offload their bonds onto the public sector. The ECB has already spent 220 billion euros buying sovereign debt with no lasting impact, and is reluctant to do more.

Italy's idea that the euro zone's bailout funds should buy bonds in the market has the same drawbacks. What's more, the bailout funds only have 500 billion euros left. If they use their firepower to bail out private creditors, they will not have enough to fund governments. Giving the bailout funds banking licences and allowing them to borrow from the ECB would solve that problem. Unfortunately, both Germany and the ECB are against the idea.

But what about a direct interest subsidy? Core countries - such as Germany and France - could pay into a pool an amount that depended on how much their cost of funding was below the euro zone's average. Peripheral countries - such as Italy and Spain - would then take a sum out of the pool depending on how much their cost of funding was above the average.

The idea recently surfaced in an article by Ivo Arnold, programme director of the Erasmus School of Economics in Rotterdam. It has also been touted by Pablo Diaz de Rabago, economics professor at the IE Business School in Madrid. But it has not yet had much oxygen.

Under such a scheme, the final cost of funds paid by all countries could be equalised or just narrowed. The key questions are: would it work, would it be politically acceptable and is it legal?

First, look at workability. An interest subsidy would help the peripheral countries in two ways. They would benefit from cash payments from the core. But the yield they pay on their own bonds would also drop as worries about the sustainability of their finances eased.

The yields on core bonds, by contrast, would rise. Investors would be worried that Germany and others were shouldering part of the burden of bailing out their neighbours. What's more, some of money that has rushed into German bonds in recent years would flood out. But, in a sense, this would just be giving back to the periphery a windfall Berlin has enjoyed as investors have panicked over the possibility of a euro collapse.

My colleague Neil Unmack and I have crunched the numbers. Suppose the yield on Spanish and Italian bonds fell by one percentage point as a result of the scheme, and that the yield on the bonds of core countries rose by 50 basis points.

Also assume that core countries were willing to make up half the remaining difference between their interest rates and those in the periphery. That would limit the scale of the subsidy while maintaining pressure on peripheral countries to reform. In this scenario, Spain's cost of borrowing for 10 years would drop to 4.4 percent, while Italy's would drop to 4.1 percent - no longer worrying levels.

Now look at political acceptability. The interest subsidy would start off being cheap. On the above assumptions, the first year cost would be only 1.9 billion euros, about 60 percent provided by Germany. Each year, of course, the cost would mount, as countries added new debt to the scheme. But the cumulative cost over the first seven years would still be a manageable 53 billion euros. The core wouldn't have to guarantee the periphery's debt. And subsidies could be provided one year at a time. So if a country didn't keep up with its reform programme, it could be kicked off the scheme. What's more, if markets settled down, the operation could be wound down.

Such limitations mean the scheme would be unlikely to fall foul of the German Constitution or the no bailout clause in the EU treaty. Of course, investors may not be convinced that the safety net is strong enough. So it wouldn't remove the need for

Europe's leaders to come up with a credible long-term vision as well as continue with their reforms. But interest subsidies are still a reasonably cheap and practical answer to the zone's most pressing problem.

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ON THE COVER

Man looks through glass door of Academy of Arts in Berlin that features graffiti that quotes German Chancellor Merkel. 03/07/2012
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