Euro panic fades, but risks linger

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INSIDE EUROPE

PARIS What a difference a few weeks make.

In early June, doomsayers were predicting the demise of the euro after a €110 billion, or $145 billion, bailout for Greece and an €800 billion financial safety net for the rest of the 16-country euro area failed to calm market panic.

European banks were hardly lending to each other, the euro had hit a four-year low against the dollar, and there was widespread talk that Greece would have to default on its debt.

''We are assigning a higher and higher probability to a breakup of the euro zone,'' Gina Sanchez, director of equity and asset allocation strategy at Roubini Global Economics, said in June.

''I don't want to overstate that,'' she added. ''It's not our base case, which is they muddle through.''

Among the grounds she cited for a possible collapse were a lack of political will to cut budget deficits and Germany's reluctance to foot the bill for rescue packages.

Just two months later, the euro zone's crisis has eased and there are signs of a return of investor confidence.

The euro has gained 10 percent against the dollar; economic recovery in the euro area is more robust than forecast, although uneven; European stocks outperformed the Standard & Poor's 500-stock index in July; and interbank lending has thawed after the publication of results for stress tests on European banks.

A healthy crop of first-half corporate earnings, including those for major euro-zone banks, and a positive report card on Greece from the International Monetary Fund and the European Commission have encouraged a more optimistic mood.

The risk premium that investors charge to hold the debt of peripheral euro-zone states like Spain, Portugal, Italy and Ireland has shrunk to the lowest levels since April. Spain's borrowing costs fell sharply at an auction of three-year bonds last week, and the cost of insuring Spanish and Portuguese debt against default has also tumbled on the market for credit default swaps.

Stress tests on European banks, scorned by many analysts as too soft when only 7 banks out of 91 failed, largely did the trick by providing detailed data to show that most were in reasonable health and could withstand the main sovereign risks.

The European Central Bank has almost stopped purchasing government bonds from the euro zone's weaklings, an emergency measure initiated to stabilize the bond market at the peak of the crisis in May.

The speed of the reversal in sentiment raises the question of whether the risks of a euro-zone breakup and a rolling government debt crisis were exaggerated from the start.

ALEX DOMANSKI/REUTERS

Jean-Claude Trichet of the European Central Bank says he is not declaring victory.

Undoubtedly, the euro jitters were amplified by enduring hostility to the euro currency project in London — Europe's biggest financial center — and skepticism in the United States.

Unnerved by the European Union's fractious and convoluted policy process and by domestic resistance in Germany, markets underestimated the political will of core governments to do whatever it took to stabilize the euro area.

They also seemed to have grossly overestimated the financial and political fragility of Spain, which was briefly seen as the next Greece and the straw that could break the euro zone's back.

So has the crisis gone away, or is it just taking a summer siesta?

Jean-Claude Trichet, the E.C.B. president, was rightly cautious when he said last week, ''I do not declare victory.'' Money markets are improving but have not yet returned to normal, he noted.

Smaller banks, notably in southern Europe, are still shut out of interbank lending, as counterparties doubt their solvency.

Many other risks remain, including the possibility that as market pressure eases, governments may step back from painful but necessary bank restructuring, budget cuts and long-term economic overhauls because of political and social opposition.

It will take years of unpopular cost-cutting reforms of pensions, labor markets, welfare benefits and the public sector to reduce bloated budget deficits and national debt piles.

Despite its impressive progress report, many analysts say that Greece may yet have to restructure its debt, requiring bondholders to take a haircut — accept a reduced value for their holdings — although that process could be postponed for three to five years because of the bailout by the Union and the I.M.F.

The euro zone's economic recovery is likely to slow as austerity measures curb public and private demand, making it harder to reduce unemployment.

Money market rates may spike as the E.C.B. withdraws more of the ample liquidity it has pumped into the banking system.

Above all, the economic imbalances and sharp differences in competitiveness between northern European euro-zone states, led by Germany, and Mediterranean countries remain unresolved.

The export-driven German economy is powering ahead, while Greece languishes in an austerity-induced recession and Spain and Portugal struggle with anemic growth while trying to curb their budget deficits.

Investors may no longer see an existential threat to the euro zone, but they see lingering problems that will make them more wary and selective than in the currency's first decade.

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