Allowing E.U. nations to feel the markets' wrath

BRUSSELS

Under German proposal, profligate states would incur higher cost of debt

BY JAN STRUPCZEWSKI
REUTERS

Planned changes to European Union budget rules are being criticized for giving politicians too much leeway in enforcing them. But a German proposal means bond markets may ultimately become the main enforcer, imposing the toughest discipline that countries have seen so far.

NEWS ANALYSIS

Under draft changes agreed to by E.U. finance ministers last week, punitive sanctions on states that spend too freely would not be automatic; any decision by ministers to move forward with sanctions could be halted by a blocking minority.

Germany, which had been advocating near-automatic sanctions, yielded to French demands for more political discretion in the process. As a result, the reforms were roundly criticized by some northern European governments and by the European Central Bank for being too soft.

But in exchange for its concession, Germany secured the backing of France to change the European Union treaty, the 27-nation bloc's main body of law, to allow the creation of a permanent mechanism to resolve economic and debt crises.

Although this aspect was not publicly stressed by Berlin and Paris, such a mechanism would involve the possibility of a euro-zone country not paying back its creditors in full, senior euro-zone officials told Reuters.

Because of this possibility, investors would demand higher premiums to lend money to euro-zone governments that appeared in danger of overspending.

That could create a strong incentive for governments to obey E.U. fiscal rules — a stronger incentive than they have faced under the current system, which does not spell out the possibility of a country partially defaulting on its debt.

"Instead of the politicians, it would be the markets punishing a country because they would know the euro zone would not necessarily come to its rescue," said Barbara Böttcher, head of European policy research at Deutsche Bank. "This would be much more efficient than the political procedure."

This year's debt crises suggest enforcement of the Union's budget rules, which stipulate that government budget deficits should not exceed 3 percent of gross domestic product while public debt must not stay above 60 percent of G.D.P., may be key to the long-term cohesion of the euro zone.

Under the draft reforms, new sanctions would be introduced for governments that did not try to bring their budgets close to balance or into surplus. Countries would be punished for tolerating, despite E.U. warnings, macroeconomic imbalances like real estate bubbles or large current account imbalances.

E.U. leaders are expected to approve the draft changes at a summit meeting late this week, after which governments will try to hammer out an agreement on numerical details like the size of fines for rule-breakers and the speed at which countries will be required to adjust excessive deficits.

The process is likely to take at least several months.

Some investors view Germany's climb-down on automatic sanctions last week as a potentially fatal flaw in the bloc's reforms.

Enforcement of the rules "is a weakness, and as long as there is a weakness financial markets could focus on it and try to take advantage of it," said Nick Kounis, chief European economist at ABN Amro.

"The compromise means that politicians are in the end masters of their own fate; that was exactly the problem with the institutional framework before," he said.

"Where we are now is not too far from where we were before," he added. "This new mechanism gives politicians a chance to interfere and get themselves off the hook — that is the risk."

Others, however, think Germany's approach to the reforms will make life much harder for spendthrift governments.

The markets would punish a country because they would know the euro zone would not necessarily come to its rescue.

In the decade after the launch of the euro in 1999, there was no provision for a country to default on its debt, so the markets assumed countries breaking the budget rules would eventually be bailed out if necessary by their richer peers.

This let profligate countries keep borrowing at ultra-low rates, giving them little incentive to tighten their belts. Fines threatened by Brussels were never imposed, and in any case would likely have been too small to force compliance; larger fines would simply have worsened countries' financial plight.

To avoid a regional crisis, Germany was ultimately forced to take part in a €110 billion bailout of Greece and to help establish a €750 billion temporary safety net for other indebted euro-zone countries.

Now, by revising the E.U. treaty to create a permanent mechanism in which countries could undergo an "orderly insolvency," Germany would be ensuring that future crises might be handled without bailouts.

This prospect would keep bond spreads high for fiscally irresponsible governments, putting them under pressure to mend their ways. In effect, Germany would be bringing in the bond markets as the top enforcer of fiscal discipline.

"In the past 10 years the market process for punishing government profligacy has not worked — the question is why?" said Elga Bartsch, an economist focused on Europe at Morgan Stanley.

"Is it because markets have always known that countries would be bailed out?" she said, adding that if a default mechanism gave markets "more ammunition to exercise their function, it might actually be a breakthrough."

Wolfgang Schäuble, the German finance minister, appeared to have exactly this logic in mind when he told the Bild am Sonntag newspaper over the weekend that holders of government bonds should "take on responsibility" during any future sovereign debt crisis in the euro zone.

Germany's approach carries risks. Even a partial default by any country could destabilize the entire euro zone.

Also, any revisions to the E.U. treaty would need to be ratified by all the bloc's 27 members — a very difficult, complex and time-consuming process that many euro-zone policy makers believe could fail.

But Germany seems to be calculating that these risks are acceptable when set against the dangers of remaining on the hook for future bailouts.

And even if Germany fails to secure the treaty revision, it has succeeded in signaling that it will not necessarily stump up money for any future euro-zone bailout.

This in itself could keep bond spreads high, partly achieving the purpose of an orderly insolvency mechanism.

"It is a puzzle with different elements, and even though each element might not be the optimal version, when they all come together, it is a major upgrade of the governance structure of the monetary union," Ms. Böttcher of Deutsche Bank said.

GEORGES GOBET/AGENCE FRANCE-PRESSE

Berlin's approach to the reforms, worked out by finance ministers in Luxembourg last week, above, will be tough on spendthrift states.

E.U. team backs tough rules for hedge funds

BRUSSELS

FROM NEWS REPORTS

Regulations that would restrict bonuses and require increased disclosure by hedge funds and private equity firms were approved Tuesday by European Union negotiators representing the European Parliament and 27 member states.

The accord allows the rules for hedge fund managers to become part of E.U. law as soon as next year.

E.U. finance ministers agreed on a compromise deal at a meeting in Luxembourg last week that gives the European Securities and Markets Authority powers over a so-called passport system for non-E.U. hedge fund managers. The European Commission proposed the rules last year.

The final version, which will go to a full vote next month, differs only in minor details from the agreement reached by finance ministers, which came after France backed down on a demand to give the new markets watchdog responsibility for issuing E.U. licenses to foreign funds to work across the Union.

In return, Britain agreed to delay the start of the licensing for foreign-based funds until around 2015. France hopes the watchdog will gain more powers and increase its 100-person staff over time.

"The commission's initial draft was a very wrinkly shirt, and we have managed to iron out many of the wrinkles," Syed Kamall, a Conservative member of the European Parliament from Britain, said in an e-mail.

The passport system would give managers access to investors across the Union with a single registration, in return for complying with transparency rules.

"I am particularly pleased by the truly European character of this directive," Michel Barnier, the Union's financial services commissioner, said in an e-mail.

"By guaranteeing a high level of transparency and protection throughout the industry, the directive will allow us to create a passport for all fund managers," Mr. Barnier said.

(BLOOMBERG NEWS, REUTERS)