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Disaster talk that could be disastrous

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INSIDE EUROPE

PARIS Talking about death does not make you die, an old French saying goes. But Europe is learning the hard way that talking about the possibility of default can hasten precisely that outcome.

When the history of the euro zone comes to be written, the agreement Germany hammered out last month with E.U. leaders on a crisis resolution mechanism for countries unable to service their debts may well be cited as the event that pushed Ireland over a cliff.

The insistence by the German chancellor, Angela Merkel, that private-sector bondholders be made to share with taxpayers the cost of future euro-zone bailouts helped send Dublin's borrowing costs into the stratosphere in the past two weeks.

The deal struck by Mrs. Merkel and the French president, Nicolas Sarkozy, in Deauville, France, which was then thrust on reluctant E.U. partners, was not the only factor driving Ireland to the brink.

Deepening political uncertainty in Dublin, with opposition parties refusing to back a jaded and unpopular government's austerity plans, and growing concern about the ever rising-liabilities of state-guaranteed Irish banks also played a role.

But Prime Minister Brian Cowen was clear about where the main responsibility lay in his eyes, telling an Irish newspaper that loose talk by the German and French leaders had complicated his efforts to overcome the crisis.

''It hasn't been helpful,'' Mr. Cowen told The Irish Independent of Mrs. Merkel's intervention. ''What has been said there has had, I think, an unforeseen consequence, perhaps.''

''The consequence that the market has taken from it is to question the commitment to the repayment of debt,'' he said.

Even though Ireland is fully funded until mid-2011 and does not need to return to the bond market immediately, the huge rise in Irish bond yields on the secondary market has increased pressure on the country's already battered commercial banks.

They are now largely shut out of the interbank lending market and ever more dependent on the European Central Bank for financing. Meanwhile, the borrowing costs of other peripheral euro-zone governments have also shot up, raising fears of contagion.

This was almost exactly the sequence that preceded the emergency bailout of heavily indebted Greece in May by euro-zone countries and the International Monetary Fund.

Seeking to douse a fire that some of their own leaders had ignited, the finance ministers of the biggest five E.U. members rushed out a statement last week at the Group of 20 summit meeting emphasizing that any future burden-sharing imposed on bondholders of a euro-zone state unable to meet its debts would not apply retroactively. In other words, current bondholders were safe.

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''Whatever the debate within the euro area about the future permanent crisis resolution mechanism and the potential private sector involvement in that mechanism, we are clear that this does not apply to any outstanding debt and any program under current instruments,'' the ministers said.

But much damage has already been done, and investors weighing the risk of a future ''haircut'' — or bond loss — may find that statement less than reassuring.

First, the whole debate about a resolution mechanism has made investors think that the risk that one or more euro-zone states might be unable to honor their debts is now a probability, and not just a possibility.

''The discussion of 'orderly defaults' opened Pandora's box,'' analysts at Lloyds TSB wrote in a note to clients. ''The sharp rise in yields is now all about expectations of future default — restructuring — and not difficulties in financing.''

Second, the assurance that any new terms would apply only to debt issued after May 2013, when the current temporary European Financial Stability Facility expires, and that all existing bonds were therefore safe, may not convince skeptics. After all, the problem facing Greece is that when its €110 billion, or $150 billion, emergency loan program expires in 2013, it may not be able to service a debt mountain that by then is forecast to reach 149 percent of gross domestic product.

Third, investors trying to price euro-zone sovereign risk face a prolonged period of uncertainty while the European Union haggles over a permanent crisis mechanism, then tries to turn it into a treaty amendment and have it ratified by 27 countries by 2013.

Mrs. Merkel is unlikely to back off. German voters outraged by having to rescue Greece are demanding that banks share any future pain.

Moreover, without some such guarantee of sharing the burden in the future, the German Constitutional Court may strike down Berlin's participation in the existing euro-zone safety net when it issues its ruling on the question in mid-2011, German officials say.

Ireland has not yet fallen over the cliff, and insists that it will not seek European aid, but it is clinging by its fingernails.

A Reuters poll of 30 economists last week found that 20 expected Dublin to have to seek a bailout by the end of 2011. Meanwhile, pressure continues to mount on Portugal, another euro-zone member with high deficits.

If Ireland does have to seek assistance from the €450 billion European Financial Stability Facility, created for other euro-zone states in May, it will be on existing terms, without debt restructuring or haircuts for bond holders.

Loukas Tsoukalis, a senior policy adviser to the European Commission, noted that the German finance minister, Wolfgang Schäuble, in defending Berlin's hard line on debtors, had invoked Hamlet on the need to be cruel to be kind.

''We should remember that Hamlet's story ends up with far too many deaths,'' Mr. Tsoukalis wrote in the policy journal Europe's World. ''We wouldn't want to repeat the experience, nor wait for a post-mortem to find out whether his prescription is right.''

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