Austerity plan falls short, Greece told

Lenders press on Athens €5.5bn gap

Fresh challenge for Papandreou

By Kerin Hope in Athens and Peter Spiegel in Brussels

International lenders have told Greece that the €28bn austerity package agreed to last month is no longer sufficient, and that Athens must close a €5.5bn "black hole" in the plan before it is approved by legislators next week.

George Papandreou, the Greek prime minister, has already struggled to gain support for the plan, which the European Union and International Monetary Fund have insisted is a prerequisite for a €12bn ($17bn) aid payment, which Athens must receive by mid-July or it will default on its sovereign debt.

But a technical team sent to Athens this week by the so-called troika – EU, IMF and European Central Bank – identified a financing gap of €5.5bn in the four-year programme of fiscal and structural reforms, according to a Greek official.

About €600m of that amount has to be raised by the end of the year to keep budget targets on track, the Greek official said.

Evangelos Venizelos, the finance minister appointed in last week's cabinet reshuffle, held emergency talks on Thursday with the visiting troika mission, which hoped to wrap up before the end of a summit of EU leaders in Brussels on Friday, officials said.

The revelation comes as the leaders prepared to turn up the pressure on Athens. According to draft conclusions presented to the EU heads of government on Thursday night, the leaders were to call on Athens to secure cross-party support for the measures – a tall order given that Mr Papandreou has struggled to gain his own party's backing.

"Given the length, magnitude and nature of the required reforms in Greece, national unity is a prerequisite for success," the draft said. Officials said the wording could be changed at a late-night session after it is debated at the summit.

Antonis Samaras, leader of Greece's largest opposition party, has opposed the original €28bn package publicly. Mr Samaras also arrived in Brussels on Thursday to meet fellow centre-right leaders ahead of the summit at which he is expected to be pressed to reverse course. But heading into the meeting, he refused to back down.

> 'It's the deputies who are in touch with the citizens making these sacrifices'

"The current policy mix implemented by the Socialist government calls for more taxes to an economy in an unprecedented depression," he said. "This has created obvious problems as demonstrated by all current figures."

George Papaconstantinou, the former finance minister, made several changes to the measures agreed with the troika this month so the cabinet and deputies in the governing Socialist party would agree to the package.

Mr Venizelos said he hoped to raise an extra €400m this year through further cuts in government operating expenses, with the remainder to come from a "poll tax" on higher-income earners and increases in excise taxes.

But he said that the additional measures – as well as future fiscal and structural reforms – would have to be approved both by the cabinet and Socialist parliamentarians before they could be implemented.

"It's the deputies who are in touch with the citizens making these sacrifices – the unemployed, the pensioners who are struggling to make ends meet. We have to listen," Mr Venizelos said.

Analysts said the EU and IMF were intensifying pressure on Mr Venizelos to make specific commitments on targets that had not been defined precisely in the document agreed by his predecessor. "The new minister doesn't have an economic background and there are fears measures could be relaxed for political reasons. So they are tightening the screws," said one observer.

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Fischer calls for rethink on IMF hiring

Election process

By Tobias Buck in Jerusalem

Stanley Fischer, governor of the Bank of Israel, has called on the International Monetary Fund and World Bank to overhaul the way they pick future leaders, arguing that the two institutions must stop using "*technical* and *irrelevant*" criteria.

Mr Fischer applied for the post of IMF managing director earlier this month, but was excluded from the race on the grounds that he was two years past the required age limit of 65.

"I had assumed, and I had hoped, that the IMF board would not use that issue, given that its obligation is to find the best candidate," Mr Fischer said in an interview with the Financial Times. "But evidently they felt comfortable nonetheless using that issue."

The next IMF head, Mr Fischer noted, would face a particularly tough challenge in Europe, battling an escalating debt crisis in Greece, Ireland and Portugal. "The consequences of mistakes would be serious, not only for the peripheral countries, but for the foundation stones of the modern economy, including the financial arrangement within Europe."

Mr Fischer said it was "extremely difficult" to judge whether Greece could avoid default, but warned against predictions that default was now inevitabl "The trouble with tho statements is that th were made all the tin They were made in the ca of the Baltic countries a they surmounted a cr recently which was r smaller in scale [than

> 'I had hoped [age would not be an] issue given that it obligation is to fir the best candidat

current one] . . . It reall matter of what the co is willing to do."

He highlighted two issues for European p makers. "One: what is long-term solution? what is the optimal tir The timing issue is a ous one. It is clear th decisions that were m year ago to help Greec tinue servicing its were appropriate. needs to ask whethe continues to be the ca

Mr Fischer denie design of the eurozon flawed from the o arguing that mon union could be ma work even without union. He argued the tricht treaty ...

EU hand-wringing hampers search for solutions

Brussels summit

The overhaul that could have put the bloc on the front foot was never carried out, writes **Peter Spiegel**

Silvio Berlusconi, Italy's prime minister, Donald Tusk of Poland, Germany's Angela Merkel and José Manuel Barroso meet in Brussels Reuters

As European leaders meet in Brussels with Greece potentially facing a devastating sovereign default, it is easy to forget that just six months ago it looked as though the European Union was about to turn the corner in its debt crisis.

The year started with a successful Portuguese debt auction that – with a little help from bond buying by the European Central Bank – raised €1.25bn ($1.8bn). Lisbon was forced to borrow at high rates, more than 6.7 per cent, but that was lower than many analysts had predicted.

When Spain followed with a successful auction of its own later in the month, one could almost hear officials in Brussels breathe a collective sigh of relief. Thanks to co-ordinated action, policymakers looked like they were finally beating back the bond market.

EU leaders appeared to be coalescing around a proposal to give the fund powers such as purchasing bonds on the open market or lending money to struggling countries to buy back their own bonds. The idea was to use the rescue fund pre-emptively to avoid full-scale bail-outs and prevent contagion. José Manuel Barroso, the European Commission president criticised for being too timid in the midst of the crisis, urged EU leaders to agree rapidly.

But the overhaul that could have put the eurozone on the front foot never happened.

Instead, European leaders have spent months discussing how much pain to inflict on private holders of sovereign bonds in a restructuring. They also devoted their energies to drawing up a "pact" to reform their economies – measures Daniel Gros, the Brussels-based economist, argues will solve the next crisis, but do nothing to alleviate the current one.

EU leaders insist the drawn-out process has not been for naught. Countries that long resisted economic reforms, particularly Portugal and Greece, are now addressing their structural problems and cutting their debt measures officials believe will return them to fiscal health.

"I saw a very deep recession in Sweden in the early 1990s. It took us somewhere around seven or eight years to actually solve these problems," Fredrik Reinfeldt, Sweden's prime minister, said. "What we are seeing is the beginning of their efforts, but it will probably take a long time to solve deep-rooted problems that should have been addressed very many years ago."

But policymakers elsewhere, including in the US, are growing exasperated with the months of public hand-wringing.

"The simple rule in crisis management is: you want to have a simple, clear, unified declarative strategy," Tim Geithner, the US Treasury secretary, said this week on the bickering across the Atlantic.

Europe's debate over how to deal with private bondholders has been particularly wrenching. Germany has for weeks threatened to press holders of Greek debt into swapping their current holdings for new bonds that would not be paid back for seven years.

Berlin insisted that bonds issued by the eurozone's permanent €500bn bail-out fund would have preferred creditor status, implying that private debt holders would suffer losses in the event of a debt restructuring. The ensuing bond market panic helped push Ireland into a bail-out.

At this week's summit, both ideas will be formally abandoned. Some German analysts argue the exercise was a political necessity, important to convince German voters Angela Merkel, German chancellor, did her utmost to reduce the public cost of bailing out weaker eurozone countries.

"Europe is now trapped in a political and civilisational crisis," said Donald Tusk, Polish prime minister. "Nobody says it aloud yet but everyone can sense it: it questions the future of the European Union."

Brussels blog: www.ft.com/brusselsblog

Growth slows across region

Eurozone economic growth has seen a sharp loss of momentum, with even Germany's powerful industrial sector unable to escape the headwinds damping activity around the world, **writes Ralph Atkins.**

Purchasing managers' indices for the 17-country eurozone dropped markedly in June, indicating private sector activity had expanded at the slowest pace in almost two years. The deceleration was especially strong in manufacturing. Economic activity outside Germany and France contracted for the first time since late 2009.

The slowdown will add to the region's difficulties as it grapples with the debt crisis engulfing Greece – but seems unlikely to stop the European Central Bank pressing ahead with another interest rate rise next month to head off inflation dangers.

Led by rapid growth in Germany, the eurozone economy saw a robust expansion in the first three months of this year, when gross domestic product was 0.8 per cent higher than in the previous quarter. But growth since then has been hit by higher oil prices, worries about global economic prospects, fiscal tightening in many countries and the supply chain disruption caused by Japan's earthquake.

Timeline

- **Autumn 2009**: Concerns grow over the debt burdens of many European countries, especially Greece

2010

- **Spring:** Austerity sweeps Europe as capitals north and south announce swingeing cuts to public spending and reforms to labour markets in reply to swollen deficits and mountains of debt
- **April**: Eurozone finance ministers approve €30bn aid mechanism for Greece – Athens declines
- **May**: After riots and rapid downgrades, Greece agrees €110bn bail-out with EU and IMF, which announce emergency safety net – the European financial stability facility – worth €750bn to protect euro against contagion
- **Aug-Sep**: EU and IMF give Greece green light for more loans under bail-out and praise Athens' reforms
- **Autumn**: Euro slides; other members in focus; Europe's top economics official, Olli Rehn, denies Ireland needs bail-out
- **Nov**: After pumping billions into its banks while slashing public pay and welfare, Ireland begs for help and EU-IMF offer €85bn rescue. European Commission president, José Manuel Barroso, says Portugal not next in line

2011

- **March**: Eurozone chiefs agree "grand bargain" of area reform, boosting lending capacity of EFSF so it can bail out more countries if necessary. A permanent, post-2013 fund – the European stability mechanism – announced, able to lend up to €500bn
- **April**: Portugal gives in and requests rescue deal
- **May**: €78bn deal made with Portugal; talks begin on new Greek bail-out; attention turns to Spain

Europe's return to Westphalia

Philip Stephens

Angela Merkel and Nicolas Sarkozy are forever protesting that the euro and the European Union are indivisible. They mean well. The purpose is to reassure: Germany and France will rescue the single currency because its failure would herald the collapse of the entire European enterprise.

The two leaders may well be right in this analysis. But setting the bold rhetoric alongside the chronic hesitations and indecision of the past year invites another possibility: that cause and effect are running in the opposite direction.

The euro is in trouble because Europe is in trouble. The sovereign debt crisis is symptom as much as cause. Greek profligacy, Ireland's housing boom and Germany's reckless state banks all played their part. But the failure to put things right speaks to a deeper malaise.

European governments can save the euro if they so choose. Orderly default by the weakest economies need not be a catastrophe if accompanied by a credible plan to underpin their future solvency and to shore up vulnerable banks in creditor countries.

The public debt of Greece, Ireland and Portugal adds up to about €680bn ($960bn). That sounds a lot. But it represents only about 7 per cent of eurozone output. Underwriting the debt by issuing Eurobonds would end the panic in financial markets.

Fixing the problem, in other words, is politically painful but perfectly possible economically. The missing ingredients are trust and political will. Voters in Germany are unpersuaded their prosperity is tied to the euro's survival; and voters in debt-laden nations need to see a plausible path out of the present trap. Ms Merkel, in particular, has to show the leadership that connects ends to means.

A little while ago I spoke at a small gathering hosted by Portugal's Fundação Oriente at the Arrábida monastery near Lisbon. I called my contribution "Europe's return to Westphalia". The thesis – that the Union is turning back the clock a few hundred years as it succumbs to the pressure of resurgent nationalisms – was intended as a provocation. As I watch Europe's leaders stumbling through the debt crisis I am increasingly persuaded that this is no more than a simple description of present reality.

The modern European state was born with the peace of Westphalia in 1648. The doctrine of state sovereignty replaced the waning supranational authority of the church. As the distinguished Brussels diplomat Robert Cooper has observed, Europe's rulers purchased domestic order and popular consent at the price of more competition between states.

This system endured until the middle of the 20th century, when the appalling devastation wrought by the second great war within 30 years finally persuaded the continent's leaders that the cost of sustaining a European order based on the balance of power had become too high.

Berlin has not been alone in turning inward. In Paris, more Europe used to mean more France

Europe's postmodern experiment in shared sovereignty has so far lasted 60 years. Now the bargain is unravelling as governments once again separate narrow national from wider mutual interests. The world has globalised, but politics remains local. Europe's states are responding to domestic pressures by seeking to reclaim Westphalian independence.

Not long ago the Union was held up as the model for the new multipolar international order. By pooling sovereignty, Europe had cracked the big challenge of globalisation: how to marry cross-border interdependence with national politics. Integration turned a zero-sum game into a positive-sum game.

A common assumption at the opening of the present century was that it would take time for others to acquire the necessary political and economic sophistication, but the EU would eventually become a template for Asean, Mercosur and the rest.

In retrospect, the glue of European integration had already begun to dissolve. The 1991 Maastricht treaty that gave birth to the single currency now looks like the last hurrah of the generation that saw European unity as vital to the continent's peace and security.

The treaty coincided with the collapse of the Soviet Union and with German reunification. The imperative of Franco-German reconciliation, postwar German guilt, and the existential threat of communism would soon be consigned to the history books. Once democracy was established in the eastern half of the continent, the EU needed a new raison d'être.

German reunification disturbed the delicate balance of a Union founded on the Franco-German alliance. Berlin's demand that Germany be treated – like Britain, France or Italy – as a "normal" (ie selfish) country has further upset the equilibrium. Germany is too big and too powerful for Europe to survive its pursuit of narrowly defined national interests.

Berlin has not been alone in turning inward. In Paris, more Europe used to mean more France. But the French, the Dutch and others have caught the British disease. Euroscepticism is no longer the sole property of Englishmen reliving the Battle of Britain.

The economic crisis has seen governments across the continent reframe Brussels as part of the problem rather than a solution. Thus the arrival of 25,000 refugees in the wake of the Arab uprisings brought a clamour in Italy, France and Denmark for tighter border controls.

The mindset of the moment is that power ceded to the Union is authority subtracted from national capitals. Governments weakened by globalisation find their citizens demanding greater security. The response to the clamour is to "stand up" to Brussels and refuse to help out their neighbours.

There is no logic here. As the centre of global gravity shifts ever faster towards rising nations, the fragmentation of Europe will only accelerate the pace of its decline.

There is, though, an irony: the new powers with which Europe must now compete have never been much convinced by the Union's postmodernism. Jealous of their sovereignty, the Chinas, Indias, Brazils and the rest much prefer the Westphalian system. Their model is 1648 rather than the Treaty of Rome.

So history may look back on the past 60 years as an interlude. The leaders at the Brussels summit this week may yet come up with a plan to save the euro. I am not sure they know how to save Europe.

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Greece's euro exit can now only be a matter of time

Samuel Brittan

If something is unsustainable it will not be sustained. But it still might be kept going for quite a long time. This was the story of Harold Wilson's long but vain attempt to stave off the 1967 devaluation of sterling. It was the story of the attempt of successive US presidents to maintain the fixed official dollar price of gold. In the final few years it only applied to gold for official transactions, but even that was abandoned by the Nixon administration in 1971. Sometimes it works the other way round, as in the unsuccessful attempts of German governments to prevent the appreciation of the D-Mark in the 1960s. There are those who say this is happening again with the unrealistically low implicit German exchange rate against the euro. And for all I know Roman emperors tried to persuade their subjects that the denarius in their pockets had not been devalued.

A Greek debt default, however disguised, is a foregone conclusion. More interesting is the fate of the euro. On November 5 last year, I wrote that Greece should and would leave the euro, but most certainly could not give a date. Little has changed since then despite the increasing complexity of the financial packages being negotiated to save Greek membership. It is time to look at what the UK chancellor Denis Healey used to call the real economy. Greek unit labour costs have risen by 50 per cent since 2001. This compares with a eurozone average of about 25-30 per cent and a German cost increase of little more than 6 per cent. Even Portugal has a much lower increase than Greece of some 36 per cent.

One's first impression is that Greece needs to parachute downwards from the euro and Germany to balloon upwards; and first impressions are not always wrong. Even a return of the Greek military dictatorship would be hard put to reverse this cost disadvantage with a frozen parity against Germany.

The establishment of the euro was a gamble that the institution of a common currency would itself make for real convergence. There are Greeks who are more cynical and say the purpose was to enable Greek leaders to borrow at German-type interest rates for dubious projects. In any case the gamble has failed and the question is how to clear up the mess. There is no real comparison with regional problems inside a single country. Regional subsidies are given as a substitute for severe cost-cutting by the less favoured areas. They are not given to allow these areas to notch up costs to much higher levels.

Any disastrous policy leads to damage. But will a Greek euro exit make the damage worse by inflicting damage on international banks? Charles Dumas of Lombard Street Research effectively answers: "No more than they will anyhow and probably less." Inside the euro, and with drastic contractionary policies imposed by the EU, debt will mount indefinitely until it is written off by default. As he writes, the losers from Greece leaving the euro "would be the bulk of the continental European elite which has hitched its wagon to a falling star – a black hole would express it better – since the early 1990s. This elite would be shown up for the arrogant blunderers they have always looked like."

Historical precedents are never exact. But Greece's predicament today has been compared with that of Argentina's a decade ago. For many years the peso's one-to-one peg with the dollar, enforced with the aid of a so-called currency board, was regarded in some circles as God's gift to mankind. But a severe capital flight caused the government to abandon the peg and repudiate foreign debt in 2001-02. For good measure it also broke off relations with the International Monetary Fund. Initially there was a severe slump. But then the economy rebounded and has since been growing in

The common currency gamble has failed and the question is how to clear up the mess

high single-digit annual percentages. So, however, has inflation, although all Argentine statistics are highly contentious.

One could not claim that the country has been a liberal paradise. President Néstor Kirchner, who took office in 2003 and was succeeded by his wife, was a populist semi-Peron figure. Both have thrown their weight about in all sorts of ways. At one stage, economic consultancies were given 48 hours to spell out how they calculated their pessimistic inflation estimates or face big fines. It is touch and go whether Cristina Fernández will be re-elected late this year. But Argentine experience does at least prove that a country can survive the end of a currency peg and telling the international financial establishment to get lost without itself permanently going down the drain pipe.

But to come back to the euro area. It is naive of journalists to expect European governments to publish a plan B, C or D in the event of failure of their original intentions. But if it turns out in the end that finance ministries and central banks have not made contingency plans for the partial or complete disintegration of the eurozone they will indeed have been guilty of a grave dereliction of duty.

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● A second glance at Barack Obama's speech on the withdrawal of US troops reveals something more interesting than the high cost of the war, **writes Ayaan Hirsi Ali**. In between the lines, what the US president said amounts to an elimination of a key component in the Afghanistan and Iraq wars, and the elevation of a minor practice.

The eliminated component is the counter-insurgency programme that in practice is a euphemism for nation building. The elevated one is the use of drones and targeted bombing of selected individuals and groups. This is a new counter-terrorism strategy.

Opting for drones abroad and trying terrorist suspects in regular criminal courts confuses the already muddled "war on terrorism", now renamed the "war on violent extremism".

From the perspective of the Taliban, the withdrawal of American troops is a sign of US weakness and their strength. And it is not only the Taliban that will see it this way: the Iranian regime, the Assad family in Syria and the malignant units in the Pakistani military and secret service see a weak America that roars but retreats when the going gets tough.

● The Afghanistan pull-out reflects where America's challenges stand today, **Xenia Dormandy** writes in reply to Ayaan Hirsi Ali's A-List column.