Markets rocked as debt crisis deepens

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Italy and Spain see borrowing costs soar

Europe fallout hurts global stocks

By Richard Milne in London and Peter Spiegel in Brussels

Europe's debt crisis deepened on Monday as Italy and Spain saw borrowing costs soar by record amounts, hitting bank shares and stock markets globally.

Italy, the eurozone's third-largest economy and home to the continent's biggest bond market, saw the premium it pays to borrow over German debt rise by more than a quarter to 3 percentage points, a euro-era high. Spain's benchmark borrowing costs rose above 6 per cent, also a euro-era high.

The sharp market moves came as a consortium of large European banks with holdings of Greek bonds demanded that the European Union commit itself to a buy-back of the debt, possibly with billions in government money. Without quick action, they warned, countries like Spain and Italy could be sucked under.

"It is essential that euro area member states and the [International Monetary Fund] act in the coming days to avoid market developments spinning out of control and risk contagion accelerating," said a six-page paper presented to eurozone finance ministers by the banks on Monday.

Market participants described the day as one of the most dramatic of the 18-month-long crisis. "We are now in the most critical phase of this crisis. Essentially a new leg in the credit drama has been opened and it is a very worrying one given the size of Italy's markets," said Nicholas Spiro, founder of Spiro Sovereign Strategy.

Investors warned that Europe's current policy would be unlikely to be able to deal with Italy, which has €1,600bn of outstanding debt in bonds and bills, if it becomes fully ensnared. "Once Italy gets involved it starts to be a situation that politicians alone may not be able to solve," said Jim Reid, credit strategist at Deutsche Bank.

Shares in Italian banks – the largest holders of the country's debt – came under further pressure with Intesa Sanpaolo down 8 per cent and UniCredit off 6 per cent after the Italian market regulator forced investors to disclose their short selling positions. Intesa and UniCredit's shares are down 20 per cent and 25 per cent respectively in the past eight days.

The proposal by the Institute of International Finance, representing the banks, which was obtained by the Financial Times, would vastly expand the scope of the Greek bail-out and could encounter political resistance, especially from Berlin.

Stock markets fell globally with the S&P 500 down 1.6 per cent in midday New York trade, France's CAC 40 off 2.7 per cent and the FTSE 100 in London slipping 1 per cent.

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Video at www.ft.com/lexvideo

Fears for Greek recovery hopes drive change in tack by Europe

News analysis

The latest move by leaders identifies a different threat: the level of debt itself, write **Peter Spiegel** and **Richard Milne**

An insistence by major European banks that the European Union must commit to a buy-back of Greek sovereign bonds would vastly expand the scope of the second bail-out for Athens and could encounter political resistance, particularly in Berlin.

The banks, led by the Institute of International Finance, has been negotiating with European officials for weeks on a plan for them to shoulder up to €30bn ($42bn) of a new €115bn Greek bail-out by exchanging their bond holdings for new, longer-maturing debt.

But the new plan appears to make banks' agreement contingent on the buy-back plan, which the IIF says is essential to lower Greece's overall debt burden, which stands at about €350bn, and return the country to fiscal health.

"Plans focused solely on covering Greece's financing needs without debt reduction will not work at this stage to stabilise markets and reverse contagion," reads the proposal, contained in a paper presented to eurozone finance ministers on Monday and obtained by the Financial Times. A European official said the EU has agreed that cutting debt levels should be the "headline objective" of the bail-out.

€350bn

The amount of Greece's debt load

52 cents

The level in the euro 10-year Greek bonds were trading at

Such a move by European leaders to tackle Greece's towering debt pile may seem a technical shift by officials who have lurched from one idea to another trying to stem the 18-month-old debt crisis. But the change in strategy, if adopted by the euro's 17 member states, would represent a break from past efforts to delay the day of reckoning and signals a change in what the European Union views as the biggest threat to the bloc's financial stability.

For most of the crisis, the biggest perceived danger for policymakers has been "contagion" – when fear grips the bond markets and drives up borrowing costs for all peripheral eurozone countries. It was on show again on Monday with rises in Italian and Spanish market interest rates.

The latest change in tack identifies a different threat: the level of Greek debt itself. The new assumption is that unless Greece can bring down its overall debt level its economy will never recover, since the government will be unable to invest and private lenders will never believe that their money is safe.

"The existing EU-IMF programme, where the official sector slowly increases the ownership of Greek debt, has not dispelled investor concerns about an eventual default," said Antonio García Pascual, chief southern Europe economist at Barlays Capital.

However, Monday's market reaction suggests that European leaders could be in trouble either way. Bond yields, which reflect market interest rate and move inversely to prices, rose in Italy, Spain and other peripheral countries to new records, while German Bunds, the eurozone's safe haven asset, dropped to their lowest since November. "If they start to talk about cutting the debt etc they may intensify some of the problems, as we'll need to see how the losses will filter through the financial system," said Jim Reid, credit strategist at Deutsche Bank.

A change in focus by policymakers means that instead of delaying payments to private holders of Greek debt – the original goal of talks with German and French banks – large swathes of debt will need to be eliminated. "The headline objective is to improve debt sustainability and reduce the debt burden of Greece," said a senior European official.

If this is the intention options such as a voluntary debt rollover, pushed by French banks, become something of a sideshow. Bringing down Greece's debt levels means massive repurchases of debt on the open market. Under such a scheme, bondholders would sell their holdings, often at a slight premium to current market prices but well below face value – locking in losses, but also certainty while cutting Greece's debt burden. Benchmark 10-year Greek bonds were trading at 52 cents in the euro last night, showing the scope for this method of cutting the debt pile.

This idea has been pushed in the past by the European Commission and the European Central Bank but rejected by Germany. Olli Rehn, the EU's senior economic official, this year advocated overhauling the eurozone's €440bn bail-out fund, the European financial stability facility, to allow it to dip into the bond market and buy Greek debt. Berlin objected, however, amid fears that European taxpayers would be on the hook for billions in repurchases.

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Europe need not slide into disintegration

George Soros

The European Union was brought into existence by what Karl Popper called "piecemeal social engineering". A group of far-sighted statesmen, inspired by the vision of a United States of Europe, recognised the ideal could be approached only gradually, by setting limited objectives, mobilising the political will needed to achieve them and concluding treaties that required states to surrender only as much sovereignty as they could bear politically. That is how the postwar Coal and Steel Community was transformed into the EU – one step at a time, understanding that each step was incomplete and would require further steps in due course.

The EU's architects generated the necessary political will by drawing on the memory of the second world war, the threat posed by the Soviet Union and the economic benefits of greater integration. The process fed on its own success and, as the Soviet Union crumbled, it received a powerful boost from the prospect of German reunification.

Germany saw it could be reunified only in the context of greater European unification, and it was willing to pay the price. With the Germans helping to reconcile conflicting national interests by putting a little extra on the table, European integration reached its apogée with the Maastricht treaty and the introduction of the euro.

But the euro was an incomplete currency: it had a central bank but no treasury. Its architects were fully aware of this deficiency, but believed that, when the need arose, the political will could be summoned to take the next step. That did not happen, because the euro had other faults of which its architects were unaware. They believed markets would correct their own excesses, so designed the rules only to rein in public sector excesses. Even there, they relied too heavily on self-policing by sovereign states.

The excesses, however, were mainly in the private sector, as interest-rate convergence generated economic divergence. Lower interest rates in the weaker countries fuelled housing bubbles, while the strongest country, Germany, had to tighten its belt to cope with reunification. Meanwhile, the financial sector was compromised by the spread of unsound financial instruments and poor lending practices.

With Germany reunified, the EU lost its main impetus for integration. With the financial crisis, it reached a turning point after Lehman Brothers collapsed and authorities had to guarantee no other systemically important financial institution would be allowed to fail. Angela Merkel, Germany's chancellor, insisted there should be no joint EU guarantee: each country would have to take care of its own institutions. That was the root cause of today's euro crisis.

The financial crisis forced sovereign states to substitute their own credit for the credit that had collapsed, and in Europe each state had to do so on its own, calling into question the creditworthiness of European government bonds. Risk premiums widened, and the eurozone was divided into creditor and debtor countries. Germany, once the main driver of integration, became the main opponent of a "transfer union".

This created a two-speed Europe, with debtor countries sinking and surplus countries forging ahead. As the largest creditor, Germany could dictate punitive terms of assistance, which pushed debtors towards insolvency. Meanwhile, Germany benefited from the euro crisis, which depressed the exchange rate and boosted its competitiveness further.

As integration has turned into disintegration, Europe's political establishment has also switched from spearheading further unification to defending the status quo. Now, anyone who finds the status quo undesirable, unacceptable or unsustainable must take an anti-European stance. As heavily indebted countries are pushed towards insolvency, the number of the disaffected grows, together with support for anti-European parties such as True Finns in Finland.

Yet Europe's establishment still argues there is no alternative. Financial authorities resort to ever more desperate measures to buy time. But time is working against them. Greece is heading towards disorderly default and/or devaluation, with incalculable consequences.

If this seemingly inexorable process is to be reversed, both Greece and the eurozone must urgently adopt a plan B. A Greek default may be inevitable, but it need not be disorderly. And, while some contagion – to Portugal and perhaps also Ireland – will be unavoidable, the rest of the eurozone needs to be ringfenced. That means strengthening the eurozone, probably by wider use of Eurobonds and a eurozone deposit insurance scheme.

Winning political support for this requires a plan B for the EU itself. Europe's elite must revert to the principles that guided the union's creation. An open society does not treat prevailing arrangements as sacrosanct; it allows for alternatives when those arrangements fail.

The status quo is now untenable, but it should be possible to mobilise a pro-European silent majority outnumbering True Finns and other anti-Europeans – to back a European solution rather than national ones.

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