FINANCIAL TIMES

EUROPE Wednesday July 13 2011

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Mao, Confucius and the search for modern China

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News Briefing

Central bankers warn on fundraising troubles
Central bankers have raised concerns that companies will face greater problems raising funds to invest in the real economy because of regulatory and accounting changes for insurers that might alter their investment style. **Page 15**

Biofuels eat up corn
US ethanol refiners are consuming more domestic corn than livestock and poultry for the first time, underscoring how a government-supported biofuels industry has contributed to surging grain demand. **Page 15; Markets, Page 27**

Ebay faces fake liability
Online marketplaces such as Ebay will have to remove advertisements for fake goods from their sites to avoid being held liable for trademark infringements, Europe's top court has ruled. **Page 15**

Ukraine probe fears
Ukraine's authorities have carried out probes at businesses owned by a tycoon linked to Yulia Tymoshenko, sparking concerns that a legal campaign against the former prime minister may be spreading to business people who have backed her. **Page 6**

Debt talks intensify
Congressional Republicans showed no sign of giving in to White House demands for new revenue to be included in an agreement to raise the US's borrowing limit. **Page 7**

UK inflation surprise
Inflation in Britain unexpectedly fell in June, relieving pressure on the Bank of England to raise interest rates soon. **Page 2**

Egyptian protests
Thousands of Egyptians occupied Cairo's Tahrir Square and locations in other cities for a fifth day, dismissing promises of reform and calling for the removal of the military council ruling the country since the regime of Hosni Mubarak, the former president, was overthrown in February. **Page 6**

US setback over jobs
The US economy added only 18,000 jobs in June in another setback to the economic recovery after a similar slowdown last summer. **Page 7; www.ft.com/us**

Trade deficit jumps
The US trade deficit jumped to its highest level since October 2008 in May. **Page 7**

China inflation fears
China's foreign exchange reserves soared again in the second quarter, adding to inflationary pressure and highlighting the risks in Beijing's policy of holding down the value of its currency. **Page 7; Comment, Page 11**

Prisoner eyes Ark Royal
Huang Guangyu, a Chinese tycoon serving a 14-year fraud sentence in a Beijing prison, has put in a bid for the retired UK aircraft carrier HMS Ark Royal. **Page 6**

Shell closer to Iraq gas
Royal Dutch Shell's drive to capture and refine gas in south Iraq has moved a step closer, after approval of the plan by the country's state-owned gas company. **Page 19**

Italy's debt costs soar in Greek contagion

Berlusconi appeals for national unity

Moody's downgrades Ireland to junk status

By Guy Dinmore in Rome and Joshua Chaffin in Brussels

Italy's borrowing costs soared to their highest level in more than a decade amid highly volatile trading as market contagion from Greece forced Silvio Berlusconi to appeal for national unity and "sacrifices" to cut the nation's debt mountain.

"We are in the front line of this battle," Mr Berlusconi said, describing a crisis that threatened all of Europe and the future of its common currency.

The Italian prime minister's appeal was intended to rebut widespread criticism in the Italian media and the markets that his coalition was rudderless and divided by disputes between him and Giulio Tremonti, finance minister.

"We have to eliminate any doubts over the efficacy and credibility of our budget," Mr Berlusconi said, insisting that a €40bn austerity package would eliminate Italy's budget deficit by 2014.

The eurozone received a further blow last night when Ireland became the third country to see its credit rating downgraded to junk status. Moody's, the US rating agency, cited the likelihood that Ireland would still need official help after its current bail-out programme ends in 2013. Its downgrade follows that of Portugal in recent weeks and Greece last year.

Opposition party leaders in Rome pledged co-operation in parliament to pass the government's three-year austerity programme by Friday in time for a possible emergency summit of EU leaders in Brussels that day.

Italian bank shares fell further at the opening of trading on Tuesday and its benchmark 10-year bond yields hit a euro-era high of 6.09 per cent before markets recovered substantially on news that Mr Tremonti was returning early to Rome from Brussels for emergency talks with the opposition. Mr Berlusconi also rushed back to Rome.

A relatively successful sale by the Italian Treasury of €6.75bn of 12-month bills – albeit at the highest yield for three years – calmed markets. France is also being affected by the volatility as the premium it pays for debt over Germany hit a euro-era high. French 10-year yields were 0.7 percentage points higher than Germany's. Mark Schofield, head of interest rate strategy at Citi, said: "France is now trading like Spain and Italy did [before this week]."

In Brussels, finance ministers agreed to enhance the flexibility of the eurozone's €440bn temporary bail-out fund – widely interpreted as a signal that the fund would begin buying distressed government bonds in secondary markets. That approach – rejected by Germany – would allow Greece to erase part of its sizeable debt burden.

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Assange in court WikiLeaks founder in extradition appeal

WikiLeaks founder Julian Assange arrives at the High Court in London yesterday where he is appealing against a lower court's ruling to extradite him to Sweden to face questioning on allegations of sexual assault against two women www.ft.com/uk AP

Murdoch faces UK political backlash

By Andrew Edgecliffe-Johnson in New York and Ben Fenton, George Parker and Salamander Davoudi and London

The British political establishment rose up against Rupert Murdoch on Tuesday, seeking to kill his attempt to buy full control of British Sky Broadcasting, just as the News Corp chairman moved to appease investors with a $5bn share buy-back plan.

The decision by the UK's Conservative and Liberal Democrat coalition government to support an opposition motion, which will today call for Mr Murdoch to withdraw his largest ever takeover bid, further reduced the media mogul's chances of salvaging the deal.

"I think he must be thinking of pulling the bid, if not tonight, then after the debate tomorrow," said one person who has previously worked closely with Mr Murdoch.

"Rupert Murdoch has no one who will speak up for him in the House of Commons. A fortnight ago he had a cabal that had the ear of everyone in government."

Mr Murdoch, his son James and Rebekah Brooks, chief executive of News Corp's UK newspaper group, were also invited to appear before a parliamentary committee next week.

The request came after another dramatic attempt by Mr Murdoch to regain the initiative, announcing that News Corp would add $3.2bn (€2.9bn) to an existing $1.8bn stock repurchase programme.

The buy-back plan briefly reversed a week-long slide in News Corp's shares. But after it emerged that the entire House of Commons would signal its opposition to the BSkyB bid, the company's shares were down four cents in afternoon trading.

The symbolic vote is not legally binding, but suggests that there is sufficient political momentum for emergency legislation to protect media plurality.

'I think he must be thinking of pulling the bid . . . It is a quite remarkable outcome'

Former Murdoch associate

The UK is unusual among European countries in not having such laws.

The developments came amid growing speculation that News Corp could seek to spin off or even sell News International, which still owns The Sun, The Times and the Sunday Times after closing down the News of the World.

In the UK parliament, MPs questioned three senior Metropolitan Police officers, two of whom led the original 2006 inquiry into phone hacking that resulted in the conviction of only one journalist at News of the World.

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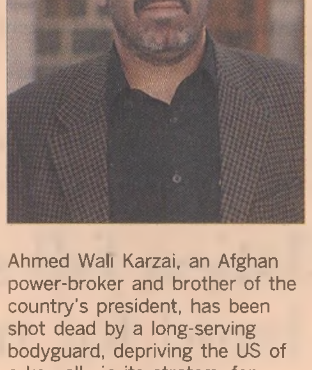
Afghan killing



Ahmed Wali Karzai, an Afghan power-broker and brother of the country's president, has been shot dead by a long-serving bodyguard, depriving the US of a key ally in its strategy for containing the Taliban as Nato troops withdraw. The Taliban claimed it had arranged the assassination. Afghan officials named the killer as Sardar Mohammad, saying that he had run Mr Karzai's security team.

Report, Page 6

Libyan regime signals Gaddafi ready to discuss standing aside

Colonel insists he must remain in the country

By Peggy Hollinger in Paris and Roula Khalaf and James Blitz in London

Colonel Muammer Gaddafi has suggested he would be willing to step aside if certain conditions were met, according to people familiar with unofficial contacts between the Libyan regime and members of the Nato-led coalition supporting the country's rebels.

Col Gaddafi's demands include being allowed to remain in Libya. The parties have also discussed whether International Criminal Court charges against the Libyan leader could be dropped. However, one person close to the coalition said such a highly controversial move would only be examined once the Libyan leader stepped down.

Alain Juppé, French foreign minister, on Tuesday confirmed the contacts, while warning that Col Gaddafi's departure was still far from certain. "It is not, today, a real negotiation," he said in a radio interview. "We are receiving emissaries who have [told] us: 'Look, Gaddafi is ready to go, let's talk about it.'"

People close to the coalition warned that the colonel's moves could be designed to buy him time rather than strike a deal. The regime, moreover, appears to be insisting that the colonel's son, Seif, should play a role in any post-Gaddafi transition.

"Gaddafi thinks the international alliance is losing patience so he's making contacts but he's not serious," said one person. "Only when the rebels get closer to Tripoli will real negotiations begin."

According to one diplomat involved in negotiations with intermediaries from Tripoli, the coalition was "closer but not close enough" to a negotiated solution.

The coalition might be willing to allow Col Gaddafi to remain in Libya, provided the country's rebel council agreed. Mediation efforts led by Jacob Zuma, South African president, have examined exile options in African Union member states.

People close to the coalition also insisted that, in the absence of a clear statement from Col Gaddafi signalling his intention to cede power, military pressure would continue.

The contacts come as France's parliament was voting on Tuesday to endorse military action in Libya. Reforms introduced in 2008 oblige the government to seek parliamentary approval for military operations after four months. The government was expected to win the vote.

www.ft.com/libya

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World Markets

STOCK MARKETS

	Jul 12	prev	%chg
S&P 500	1325.12	1319.49	+0.43
Nasdaq Comp	2803.86	2802.62	+0.04
Dow Jones Ind	12556.77	12505.76	+0.41
FTSEurofirst 300	1091.72	1097.6	-0.54
Euro Stoxx 50	2693.53	2709.14	-0.58
FTSE 100	5868.96	5929.16	-1.02
FTSE All-Share UK	3057.7	3088.28	-0.99
CAC 40	3774.12	3807.51	-0.88
Xetra Dax	7174.14	7230.25	-0.78
Nikkei	9925.92	10069.53	-1.43
Hang Seng	21663.16	22347.23	-3.06
FTSE All World $	(u)	222.61	

CURRENCIES

	Jul 12	prev		Jul 12	prev
$ per €	1.399	1.399	€ per $	0.715	0.715
$ per £	1.591	1.589	£ per $	0.629	0.629
£ per €	0.879	0.881	€ per £	1.138	1.136
¥ per $	79.5	80.4	¥ per €	111.2	112.5
¥ per £	126.5	127.7	£ index	78.7	78.6
$ index	77.7	77.9	€ index	95.07	95.30
SFr per €	1.165	1.168	SFr per £	1.326	1.326

COMMODITIES

	Jul 12	prev	chg
Oil WTI $ Aug	97.43	95.15	2.28
Oil Brent $ Aug	117.24	117.24	
Gold $	1,554.10	1,547.00	7.10

INTEREST RATES

	price	yield	chg
US Gov 10 yr	101.83	2.91	-0.01
UK Gov 10 yr	105.22	3.09	0.01
Ger Gov 10 yr	104.69	2.71	0.04
Jpn Gov 10 yr	100.85	1.11	-0.03
US Gov 30 yr	103.06	4.19	-0.01
Ger Gov 2 yr	100.84	1.30	0.05
	Jul 12	prev	chg
Fed Funds Eff	0.07	0.07	
US 3m Bills	0.04	0.02	0.02
Euro Libor 3m	1.54	1.55	0.00
UK 3m	0.71	0.71	

Prices are latest for edition

Cover Price

Albania	Lek410	Macedonia	€3.30
Austria	€3.30	Malta	€3.30
Bahrain	Din1.5	Mauritius	MRu90
Belgium	€3.30	Morocco	Dh35
Bulgaria	Lev7.00	Netherlands	€3.30
Croatia	Kn27	Nigeria	Naira715
Cyprus	€3.30	Norway	NKr28
Czech Rep	Kc115	Oman	OR1.50
Denmark	DKr28	Pakistan	Rupee 120
Egypt	E£19	Poland	Zl 15
Estonia	€3.83	Portugal	€3.30
Finland	€3.60	Qatar	QR15
France	€3.30	Romania	Ron16
Germany	€3.30	Russia	€5.00
Gibraltar	£2.20	Saudi Arabia	Rls15
Greece	€3.30	Serbia	NewD300
Hungary	Ft820	Slovak Rep	€3.30
India	Rup85	Slovenia	€3.30
Israel	ILS17	South Africa	R28
Italy	€3.30	Spain	€3.30
Jordan	JD3.25	Sweden	SKr32
Kazakhstan	US$4.90	Switzerland	SFr5.40
Kenya	Kshs300	Syria	US$4.74
Kuwait	KWD1.50	Tunisia	[illegible]
Latvia	[illegible]	Turkey	YTL6.25
Lebanon	[illegible]	UAE	Dh15.00
Lithuania	[illegible]	Ukraine	€5.00
Luxembourg	[illegible]		

Europe's debt crisis

Doubts persist over Rome's assurances

Italy

Both the nation's finances and the future of its premier are unclear, write **Guy Dinmore** and **Richard Milne**

Silvio Berlusconi's weakened coalition government is on track to win accelerated parliamentary approval of its austerity package, but economists and analysts are already warning that this is likely to prove a temporary reprieve – for Italy's straitened finances and the future of the prime minister.

After a day of wild gyrations on stock and debt markets, Mr Berlusconi sought to impress investors that his government was solid in its determination to cut Italy's debt burden and balance its budget by 2014.

Despite government assurances that the €40bn of belt-tightening measures would be sufficient to achieve these goals, many questions remain unanswered.

"Investors who look closely at the numbers in the package have reasons to worry," said Tito Boeri, economics professor at Bocconi university. The bulk of cuts and savings envisaged by the government come into play only in 2013, he notes, and more than a third of the budget correction depends on future changes to welfare legislation "whose contents are far from defined".

There are no measures to promote growth, Prof Boeri adds, echoing the concerns of rating agencies, which have downgraded Italy's outlook. The budget is two-thirds dependent on projected increases in revenues, and just one-third on spending cuts.

Government insiders told the Financial Times that additional measures were already under consideration, including privatisations and further cuts. However, they doubt that Mr Berlusconi is ready to sell the government's strategic and valuable holdings of some 30 per cent in Eni, an oil and gas company, and Enel, a utility, sale of which would raise billions.

While Italy's economy fell deeper into recession in 2009 and is recovering more slowly than its European peers, analysts also believe that market reaction has been overdone, driven mainly by speculators shorting Italian debt and banks. Italy is not Greece, they stress, pointing to a large manufacturing sector, recovering exports, lowish unemployment, a steady state pension outlook, and a banking sector which the Bank of Italy says will pass this week's Europe-wide stress tests.

This view was bolstered by Christine Lagarde, head of the IMF, who said Italy's crisis was "essentially market driven". "Some of the Italian numbers are excellent. Its primary deficit is one of the lowest," she commented on Monday.

Analysts say the volatility in Italian bonds – its benchmark borrowing costs rose by 0.4 percentage points on Tuesday morning before falling 0.5 percentage points in the afternoon – is partly down to investor positioning. Investors have sold most of their Greek, Irish and Portuguese bonds and instead looked to Italy as a relatively safe investment.

"People just panicked because they were so heavy on Italy," said one trader. "Maybe now they will start to wonder if they have oversold."

But, each 100 basis points rise in bond yields raises Italy's cost of financing by €3.2bn this year and over €6bn in 2012, economists calculate, throwing the government's best calculations into disarray. In the past two weeks, the yield on 10-year bonds rose from below 5.0 per cent to above 6.0 per cent at the worst point.

Investor opinion is more divided about Italy than any other peripheral eurozone country. To its proponents, it has long dealt with a large debt burden successfully and even has a primary surplus, leading some to believe it could serve as an example to Greece.

"Italy is actually where Greece wants to be in several years' time," says Nicholas Spiro of Spiro Sovereign Strategy. However, to its detractors the country is racked by its €1,800bn of debt and anaemic growth.

"Any sovereign with serious debt outstanding is vulnerable to a liquidity run," says Willem Buiter, chief economist at Citi. "The question of 'why now?' is a hard one, but it can always happen when countries have 120 per cent debt-to-GDP." Despite Mr Berlusconi's promises of a "liberal revolution", Italy's productivity rates have fallen over the past decade – with eight of those years under his two centre-right governments. Hampered by high taxes, an inefficient legal system and byzantine bureaucracy, the economy grew by less than 2 per cent between 2001 and 2010, far slower than its peers, and is projected to struggle to grow 1 per cent this year.

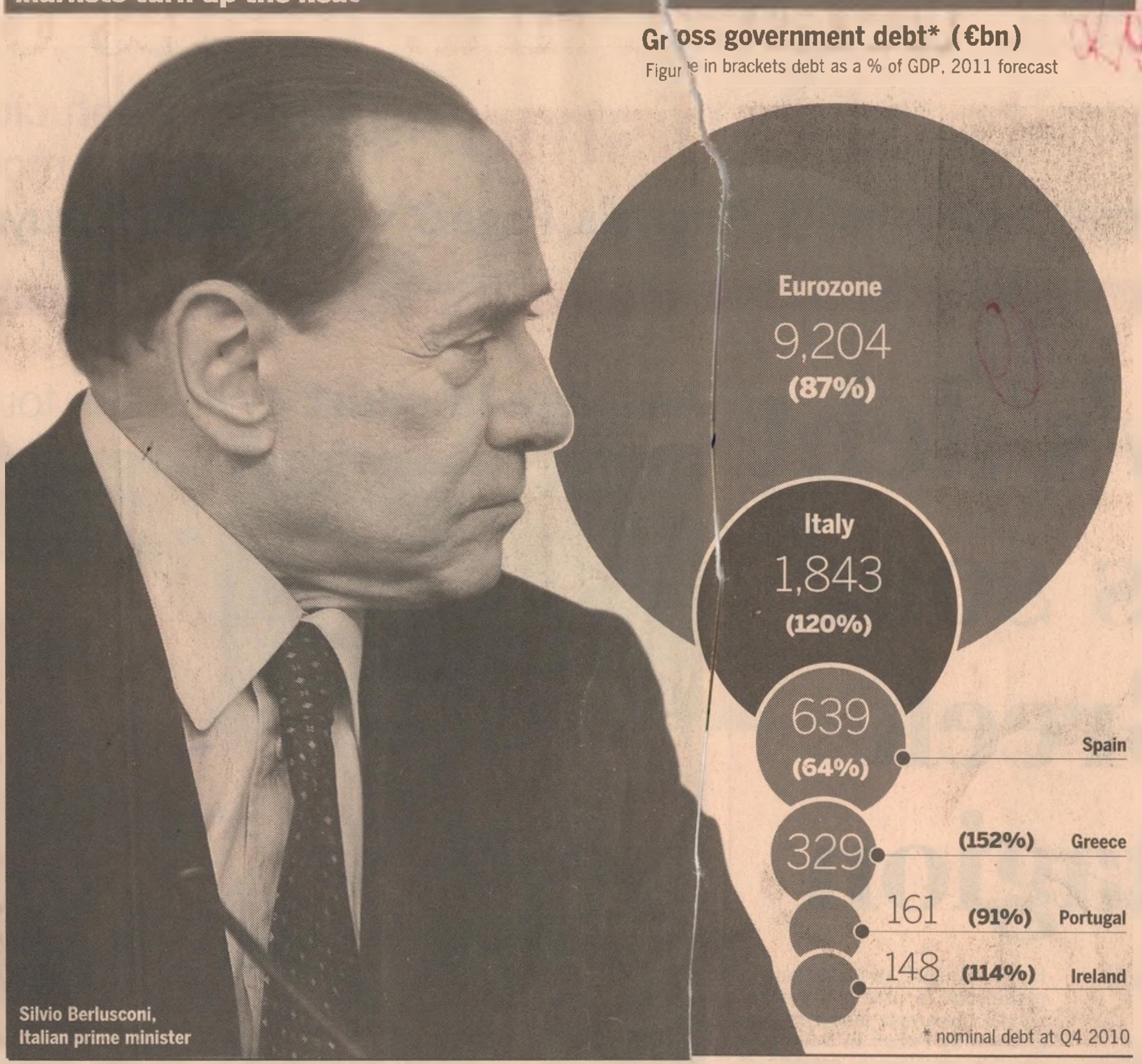
Slothful growth is also held back by an ageing and declining population that is only kept on an upward trend thanks to a sharp rise in immigration. The sense of panic has been compounded by the image of a disunited government led by a billionaire prime minister more concerned about the state of his own personal finances and his battles in the courts.

Ferruccio de Bortoli, chief editor of Corriere della Sera, wrote in a rare front-page editorial: "The drama of the market crisis exposes the loss of credibility of an executive divided by its internal theatrical rivalries and weakened by the courts' investigations."

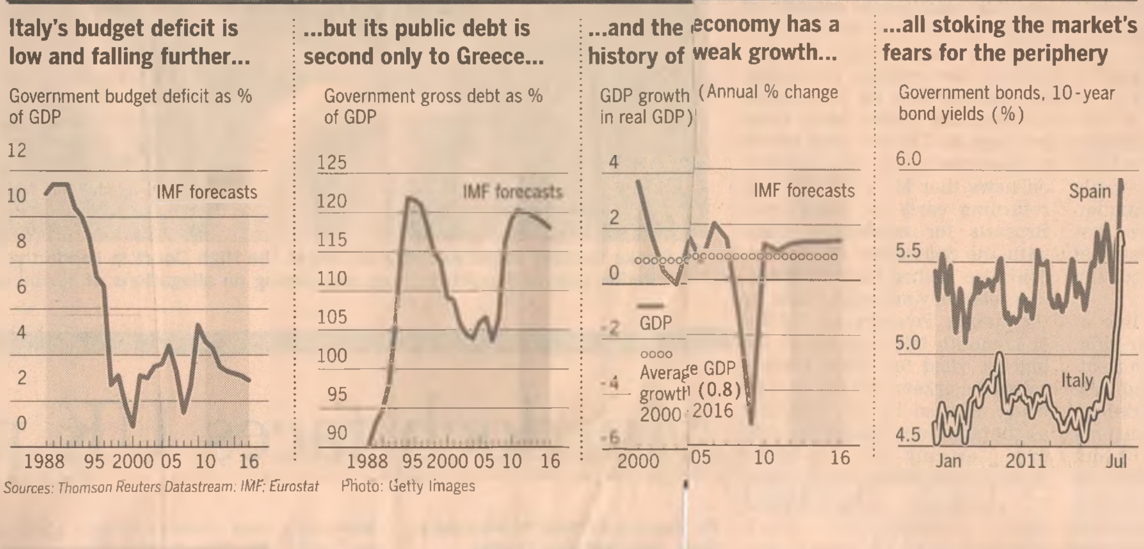
A growing perception of Mr Berlusconi as a liability is fuelling speculation that his coalition will not survive its full term to 2013.

Additional reporting by Giulia Segreti

Markets turn up the heat



Silvio Berlusconi, Italian prime minister



Sources: Thomson Reuters Datastream; IMF; Eurostat Photo: Getty Images

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John Authers and Vincent Boland on why the Greek haircut will fix Italy's short-term troubles
www.ft.com/lexvideo

Latest news and analysis of the eurozone's woes
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Germany's soft spot for Italy faces hard test in days ahead

GLOBAL INSIGHT

Quentin Peel
in Berlin

The contagion in Europe's sovereign debt markets that is spreading from Greece to Italy could scarcely have come at a more perilous and frustrating moment for Germany's anxious financial controllers.

After months of strenuous efforts to contain the effects of the debt crises in the smallest economies of the eurozone periphery, it looked as if the preferred German version of a new Greek rescue – involving private creditors as well as public cash – was close to agreement at the weekend.

According to those close to the negotiations, all it needed was a few calm weeks in the markets to finalise the complex details, and all would be well.

Private creditors would voluntarily agree to a bond swap with extended maturities, combined with some form of bond buy-back scheme financed with public cash as a sweetener. Such debt relief would then make a significant contribution to the total package, including new money from the eurozone members and the International Monetary Fund. Although Athens might be declared in selective default by the debt-rating agencies, it would be very brief – perhaps no more than a fortnight – allowing the European Central Bank swiftly to resume supplying liquidity to Greek banks.

But the flight of bondholders from Italian debt over the past few days has suddenly raised the temperature – and the pressure – for something more urgent to be done. There is a sneaking suspicion in Berlin that the market panic may have been engineered by investors desperate to avoid private creditors' participation. Germany's mandarins are adamant that they need time to get the Greek deal right and ensure a lasting solution to Athens' crushing debt burden.

In contrast, an Italian debt crisis has always been seen as too ghastly to contemplate. But the combination of Rome's huge public debt and dysfunctional political system was an accident waiting to happen

Greece, Ireland and Portugal are all small economies whose plight can be contained with the money already pledged by the eurozone partners. Spain would be a challenge, but eventually manageable. But Italy, with a debt burden of almost 120 per cent of gross domestic product, is in a class of its own.

Yet Germany has always had a soft spot for Italy, in spite of that country's addiction to public debt. Perhaps it goes back to the age-old *Drang nach Süden* – the longing for the south – that has seduced German artists and writers through the ages.

Back in the 1990s, when the rules of the euro as a common currency were being established, many respectable German voices warned against the dangers of taking in both Italy and Belgium as full members, as long as they had to service debts above 100 per cent of GDP.

Hans Tietmeyer, stern monetarist president of the Bundesbank from 1993-99, told the German parliament in 1998 that the excessive debts of both countries must be radically reduced, or they would "very quickly" cause conflict within the monetary union.

Yet, even he refused to discuss the number of founder members – that would be a "political" decision, he said.

'A breakdown of such a union would be more dangerous than not to have it in the first place'

Wolfgang Schäuble, Germany's finance minister now wrestling with today's debt crisis, says much the same. It would have been impossible to exclude a founder member of the European Community, such as Italy, from its most ambitious joint venture, he told the Financial Times last year. So Helmut Kohl, then German chancellor, agreed to a strict timetable for the euro's launch, regardless of whether all the founder members were sufficiently solvent – or competitive – to join. Greece clearly was not. Mr Tietmeyer went further: he warned about the lack of closer political integration to underpin the monetary union. "In the long run, monetary union cannot and will not survive without being embedded in a broad political, common environment," he told the FT in 1994.

He went on: "If we create a monetary union, and this proves to be a failure, this will be a very, very sad result for Europe. A breakdown of such a union would be more dangerous than not to have it in the first place."

That is the outcome Mr Schäuble and his colleagues are working day and night to avoid.

Zapatero declares 'tranquillity' over finances

Spain

By Victor Mallet and Miles Johnson in Madrid

Spain's prime minister insisted on Tuesday that there were no worries over his country's finances but said he had met his finance minister to discuss sovereign debt and the financing needs of the state.

After days of rising bond yields on the eurozone periphery that make it more expensive for countries such as Spain to borrow, José Luis Rodríguez Zapatero said: "It's negative but, from the point of view of financing the treasury, the state, there is absolute tranquillity."

He spoke after a meeting in Madrid with Herman Van Rompuy, European Council president. Mr Zapatero indirectly criticised Angela Merkel, German chancellor, for frightening investors with her suggestion that private bondholders should pay their share of a Greek bail-out.

At one point on Tuesday, the yield on Spanish 10-year bonds rose to 6.3 per cent – a record since the launch of the euro, twice the yield paid by Germany and a level that would have been regarded as critical only a few months ago. Bank of America Merrill Lynch analysts said 8 per cent was the "debt sustainability threshold" for Spain.

"This new episode of grave tension in the debt markets, which affects various countries, including ours . . . can only be solved with a firm, co-ordinated, clear and rapid European response," Mr Zapatero said, repeating that Spain's economic reforms and its plans to cut the budget deficit were on track.

For months, bond markets investors have wondered whether Spain, the fourth-largest economy in the eurozone and one heavily dependent on foreign financing, would become the next country after Greece, Ireland and Portugal to seek a bail-out, despite Spain's relatively low level of public debt.

Since Friday, market attention has shifted to Italy, a larger economy with higher public debt relative to gross domestic product.

But Spain is still in the line of fire. "It's a horrible day," said a senior banker in Madrid on Tuesday as eurozone bank share prices remained under pressure.

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Greek premier heaps blame on European partners

Athens

By Kerin Hope in Athens

Greece's prime minister has rounded on the country's European partners, claiming that "indecisiveness and errors" have fuelled the eurozone's deepening debt crisis.

"There is a greater need to avoid mistakes of the past. Crunch time has arrived," George Papandreou said in a letter to Jean-Claude Juncker, Luxembourg's prime minister and chairman of the eurogroup of finance ministers.

Mr Papandreou accused Greece's partners of "taking decisions that in the end prove too little, too late to convince markets". He complained that eurozone states were "making compromises . . . that substitute tactical politics for sound management of the crisis", and "allowing a cacophony of voices to substitute for a shared agenda".

The letter was made public on Tuesday as yields on Greek, Italian and Spanish bonds soared to record highs following demands by a consortium of European banks that the European Union should commit to a buy-back of Greek debt.

Mr Papandreou insisted that Greece was making headway with fiscal and structural reforms, saying his government had started "a process whereby implementation deficits of the past are being remedied".

Yet his deputy finance minister broke ranks on Monday night, telling parliament the country's ambitious €50bn privatisation scheme – the centrepiece of a new medium-term economic programme agreed with international lenders – would not be achieved.

"Many fewer assets will be sold than are included in the privatisation plan. It is impossible to sell them all," Pantelis Economou told the chamber.

First-half budget figures showed unexpected spending overruns and a worsening revenue shortfall, despite efforts by European Union and International Monetary Fund experts to help the finance ministry crack down on tax evasion.

The budget deficit soared by 27.9 per cent in the first six months compared with 2010, even after the public investment budget had been slashed by almost 50 per cent, according to the finance ministry.

"It is ironical that Greece is accusing its partners of having made mistakes, while itself failing to deliver on reforms that would help restore credibility with markets," said Takis Michas, a social commentator.

First-half revenues were down 8.3 per cent compared with a target increase of 7.5 per cent. Outlays rose by 8.8 per cent, indicating that the finance ministry had failed to tighten spending controls under a plan agreed with international lenders, analysts said.

"It is a disappointing situation," said one analyst. "It's going to be a real challenge for the government to make up lost ground in the second half."

UK inflation fall strengthens Bank's hand for no rate rise

Prices

By Claire Jones in London

Inflation in Britain unexpectedly fell in June, relieving pressure on the Bank of England to raise interest rates in the near-future, as prices for computer games and other consumer electronics tumbled.

UK inflation, as measured by the consumer price index, dipped to 4.2 per cent last month from 4.5 per cent in May, confounding analysts' forecasts of no change.

However, the rate remained considerably higher than the 2.7 per cent inflation that is expected to be recorded for the eurozone in June. The European Central Bank has already raised interest rates twice this year in an attempt to bring inflation in line with its target of "below but close to" 2 per cent.

The drop in the UK's headline measure – although still more than double the Bank of England's 2 per cent target – was reflected by other inflation indicators. The retail price index fell 0.2 percentage points to 5 per cent, while core inflation – which excludes fuel, food and alcohol – dipped to 2.8 per cent, a low for the year.

Howard Archer of IHS Global Insight said: "The Bank [of England] will breathe a little easier."

4.2%

UK inflation as measured by the consumer price index

The fall came on the back of lower prices for recreational goods, particularly computer games, and for clothing and footwear. Food prices, which have risen 6.9 per cent year-on-year, and transport costs, up 7.9 per cent, remained the main contributors to inflation.

Economists argued on Tuesday about the significance of the dip in UK inflation for the country's monetary policy, although most agreed it strengthened the case for the Bank of England not to raise rates.

Alan Clarke of Scotia Capital termed the drop extraordinary. "With the likelihood of a negative reading for second-quarter growth, this looks set to reinforce expectations that the first Bank rate hike is over a year away."

Allan Monks of JPMorgan said the data would "play to the argument that the current spike is transitory".

But Michael Saunders of Citi said the drop merely reflected a sooner start to summer sales than was typical, and its impact would be unlikely to be felt in subsequent months.

Inflation in the UK has been above target since December 2009. It has yet to fall below 4 per cent this year and the Bank of England expects a further rise in the third quarter as a result of higher gas and electricity bills. Two of the country's leading energy companies, British Gas and Scottish Power, have already said they will raise prices.

Shift on Greek default lifts hopes of deal

Eurozone ministers ease stance on crisis

Agreement still not certain, warn envoys

By Joshua Chaffin in Brussels, Quentin Peel in Berlin and James Wilson in Frankfurt

Eurozone finance ministers have lowered their opposition to a possible Greek debt default in order to accommodate German and Dutch demands that private creditors shoulder part of the burden of any new rescue package for the country.

The acknowledgement of a possible Greek default marks a potential turning point in the eurozone's attempts to address the crisis. It came after two days of meetings in Brussels, and against the fierce opposition of the European Central Bank, which fears that such an occurrence could unleash further turmoil in financial markets and spread contagion to other eurozone members.

Yet it appeared to unblock a contentious debate that has prevented member states from coming to terms on a new and more comprehensive package to help Greece and confront the broader eurozone debt crisis.

Expectations that such an agreement was taking shape were heightened after Herman Van Rompuy, the European Council president, began making arrangements to summon European leaders to Brussels on Friday for an emergency summit meeting. Several diplomats cautioned that Mr Van Rompuy's calls were hasty and that it remained unclear whether an emerging consensus could be translated into a binding legal agreement at such short notice.

"The key is that the debt sustainability of Greece must be improved," Wolfgang Schäuble, German finance minister, said after Tuesday's meeting. Private sector participation in such an effort, he added, was "certain".

Finance ministers have been struggling for weeks to reconcile demands by Germany, the Netherlands and Finland for substantial private sector involvement in any new bail-out – a condition that they believe is essential to win domestic political support – against the growing realisation that such an approach would be likely to trigger a default.

When they met in Luxembourg late last month, ministers agreed that avoiding a "credit event" or "selective default" remained a top priority. Yet in a statement issued late on Monday they were silent on the matter, removing an impediment to a possible deal.

"We have managed to break the knot," said Jan Kees de Jager, the Dutch finance minister, who had complained in a conference call over the weekend that the competing priorities could not be squared.

Still, during yesterday's meeting, Jean-Claude Trichet, ECB president, is understood to have maintained his fierce opposition to roping bondholders into a bail-out. European diplomats also acknowledged widespread unease at the growing possibility of a Greek default – even if it was only shortlived and selective. One of the key issues in the coming days, they said, was how to contain the blowback from such an event.

Jean-Claude Trichet, ECB president, talks to Evangelos Venizelos, Greece's finance minister, in Brussels yesterday AFP

Meanwhile, Greece's finance minister also for the first time mentioned the possibility of a selective default. Evangelos Venizelos said last night in Athens: "Selective default is not an actual event, it's an assessment [by rating agencies]." But he added: "We must not turn a perception into reality, into a self-fulfilling prophecy."

In exchange for the concession, Germany was forced to soften two of its most persistent demands for addressing the debt crisis: the first is its opposition to using funds from the eurozone's €440bn temporary bail-out fund to repurchase the bonds of distressed member governments. Advocates of that approach have argued that it could help to erase a sizeable portion of Greece's outstanding debt, leaving a more sustainable load and eventually allowing the country to return to economic health. This could be achieved without changing the bylaws of the fund, known as the European financial stability facility, which would require the approval of national parliaments. Instead, Greece or other EFSF loan recipients could use those funds to mount buy-backs on their own, officials said.

Germany has also been persuaded to lower interest rates and extend loan maturities for Greece and other countries receiving assistance. Previously, Berlin had insisted those rates be kept sufficiently high to dissuade profligate governments from seeking easy bail-outs.

Berlin is still hoping that – in addition to bond buy-backs – a bond swap could be part of a larger deal to alleviate Greece's debt. One of country's leading bankers, Martin Blessing, chief executive of Commerzbank, outlined one vision of such a plan. Commerzbank is 25 per cent owned by the German government and is the country's biggest private-sector holder of Greek bonds, with €2.9bn of exposure.

In an article in the Frankfurter Allgemeine newspaper, Mr Blessing said it was time to recognise the "reality" of the eurozone crisis, and suggested bondholders should get a 30 per cent haircut on their Greek bonds along with an exchange into 30-year bonds backed by a common eurozone guarantee. He said these could have a yield of only 3.5 per cent, well below the levels Greece would otherwise pay.

Q&A

When is a default not a default – and how much does it matter?

Wasn't the big Greek vote for austerity last month supposed to bring calm to the financial markets?
Indeed it was, because it solved the most immediate problem – the risk that Greece would be unable to make a large debt repayment in mid-July and would therefore default on its sovereign bonds. When Athens passed the measures, the European Union and the International Monetary Fund agreed to send €12bn in bail-out aid to Greece, keeping its financial head above water for another three months.

However, the EU was also expected to agree to a second €115bn bail-out that would ensure Greece would be able to continue making its debt payments through to mid-2014. So far, however, eurozone states have not been able to agree the deal.

What's the hold-up?
A group of creditor countries led by Germany wants private bondholders to bear some of the burden of the new Greek rescue, perhaps as much as €30bn. But any move that forces bondholders to accept less than they were originally promised by Athens is, by definition, a default – and markets fear that any default by Greece will set a precedent for the rest of the eurozone. That fear is now pushing up borrowing costs for Spain and Italy.

So the German-led group has been locked in negotiations with big banks, represented by the Institute of International Finance, to work out a way for them to delay redemptions on a big portion of their Greek bonds.

If the banks come to an agreement, is everything solved?
Many European leaders thought so. But the credit rating agencies have warned in recent days that even a voluntary delay on the part of bondholders would be considered a default, albeit a "selective" one. A French-backed plan, which would have seen the banks reinvest or "roll over" proceeds from Greek bonds when they are redeemed, was seen as the most likely to pass muster with the rating agencies.

However, Standard & Poor's last week said this scheme would still be considered a default. So European leaders are now reconsidering a more onerous, German-backed plan to persuade debt holders to swap their current holdings for new, longer-maturing bonds – if the agencies are going to call default anyway, at least they might achieve a more significant private sector contribution.

Does it really matter if the rating agencies call a default?
Leaders are divided on this. Many in the German-led camp believe that the effects of a selective default can be contained, since it is likely to be of short duration and is unlikely to trigger the insurance that bondholders have against debt default – known as credit default swaps. But others, including European Central Bank officials, are not so sure.

Angela Merkel: wants bondholders to help rescue

As Moody's warned last week, once European leaders decide a default, selective or otherwise, is OK for Greek bonds, what is to prevent them from making the same conclusion for other peripheral bonds? This fear is a big reason why Spanish and Italian bonds have plummeted, with panicked investors rushing to more secure debt, such as Germany's.

What can be done to combat this contagion?
There was some thinking that Germany may abandon the idea of bondholder participation altogether, but that now looks unlikely. Instead, Berlin has made concessions on two other main issues that it had long resisted: reopening debate on using the eurozone's €440bn bail-out fund to purchase Greek bonds on the open market; and lowering interest rates on bail-out loans to Greece, Portugal and Ireland.

Both moves could have a significant impact in the ability of the three countries to emerge successfully from their bail-outs, get their economies growing again and stand on their own financial feet.

Currently, all three are forced to pay a 2-3 per cent premium on EU loans, which many now consider punitive.

So where does this bond buy-back plan fit in?
A bond buy-back could be a game-changer, too. Buying and retiring Greek bonds – many of which are now trading at barely half of their face value – could reduce Athens' overall debt burden as well as get bondholders voluntarily to accept less for their investments.

IMF backs German drive

By Alan Beattie in Washington

Germany's drive to consolidate its fiscal position has received the backing of the International Monetary Fund, which says its public spending restraint is having little impact on growth in the eurozone's troubled peripheral countries.

The fund gave the advice in the first of its reports to feature the spillover impacts of the large economies' government on the rest of the world, part of the organisation's attempt to co-ordinate a reduction of global economic imbalances. "The very success of the [economic] recovery has generated calls on Germany to play a more prominent international role," the IMF report said. But it added that "the scope for policy initiatives to achieve short-term gains is limited".

Germany has been criticised by US and other politicians for continuing to run large current account surpluses, including with other eurozone countries, relying on exports rather than generating domestic demand through public and private spending.

But in its annual so-called "Article 4" assessment of the German economy, the IMF said that the government's current plans for fiscal consolidation were "appropriate" in current circumstances, though adding that the plans should be revisited if growth turned out to be much lower than expected. Longer-term structural reform including changes to the tax and educational system were needed to boost growth, it said.

Full story: www.ft.com/europe

Hacking fallout

Calls for News Corp reform intensify

News analysis

Adjustments likely for board where Mr Murdoch calls the shots, say Andrew Edgecliffe-Johnson and Dan McCrum

News Corp's corporate governance has long been seen as a pact between unthreatening directors and compliant shareholders, unwilling or unable to stand up to the wishes of Rupert Murdoch and his family, which uses a dual-class share structure to control almost 40 per cent of the votes.

With another 7 per cent of the voting rights in the hands of Prince Al Waleed bin Talal of Saudi Arabia, who this week told the FT "this is the time for a loyal shareholder to stand by his friends and allies", almost nobody expected that pact to change any time soon.

Nell Minow of Governance eMetrics International, which rates the effectiveness of boards for insurers, investors and others, wrote on Wednesday: "We've consistently given News Corp an F, only because there is no lower grade."

"I always assumed the board was under Rupert Murdoch's thumb, and basically one of those governance situations where he called the shots," added Jim Kristie, a corporate governance commentator and editor of Directors and Boards. Investors buying into News Corp "know they're buying stock in Rupert Murdoch".

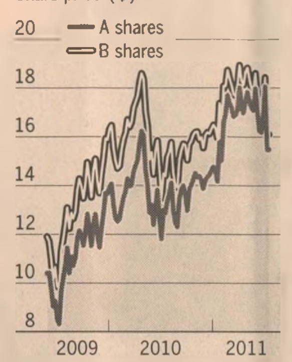
Analysts' bullishness on the prospects for much of the company, notably the cable networks anchored by Fox News and the Fox broadcasting network, has kept shareholder pressure to a minimum. However, many analysts and investors now think there will be a change in governance and investor relations.

News Corp's board features some big names, including José María Aznar, the former Spanish prime minister, and John Thornton, a former Goldman Sachs president. But it flouts many conventional definitions of board independence: Kenneth Cowley, a former News Corp executive, has sat on the board since 1979.

Mr Murdoch and his sons Lachlan and James already sit on the board, and his daughter Elisabeth, a board observer, is expected to become a full director after the company buys Shine, the TV and film production company she founded.

A group of small institutional investors had already challenged what in March they called nepotism and poor governance by filing a class-action lawsuit in Delaware against the board after News Corp bought Shine. This week the shareholders, led by Amalgamated Bank and municipal and union pension funds, amended their complaint to reflect the hacking scandal, claiming: "These revelations show a culture run amuck within News Corp and a board that provides no effective review or oversight." News Corp has brushed off past attacks by such shareholder groups, however, and it remains unclear whether liability for the scandal will touch any members of the board.

News Corp
Share price ($)



Source: Thomson Reuters Datastream

Yet Ms Minow argued: "Maybe the various investigations and a compelling shareholder lawsuit will inspire them to develop some courage. More likely, a few calls to their lawyers will scare them into doing the right thing."

More shareholder lawsuits are possible, said Howard Godnick, partner at Schulte Roth & Zabel: "There is a potential breach of fiduciary duty claims if you can place wrongdoing high enough in the organisation." Even absent actual knowledge, a failure to supervise could be grounds for a case, he added.

People who have been close to the company for many years wonder who on the board would stand up to the Murdoch family. Some point to Tom Perkins, the Silicon Valley investor, who quit the board of Hewlett-Packard over a scandal in which HP board members were spied on.

Investors believe that Mr Murdoch may hand his chief executive title to his well-regarded chief operating officer, Chase Carey, and retain the chairmanship, but they doubt that his grip would be shaken meaningfully.

Credit Suisse analysts wrote on Wednesday that James Murdoch's admission that he was unaware of material information when he approved out-of-court settlements "may call into question his supervisory role as a director".

Brett Harriss, research analyst for Gabelli and Co, with a holding below 1 per cent, said: "I don't think Murdoch will step down. This is his empire, he has voting control and the heirs apparent are his children."

Unless it goes right to [Rupert] Murdoch, adjustments will be made", one hedge fund manager said, predicting little long-term harm to News Corp, so long as problems are contained in the UK.

Directors have been holding conference calls, but have said nothing in public about the hacking scandal and its aftermath until Tuesday's announcement of an increased share repurchase programme. The move, answering investors' perennial calls for buybacks, was approved by the board, the statement said.

"Pressure is growing for News Corp to address equity returns to shareholders," Michael Nathanson of Nomura wrote before Tuesday's buy-back announcement. That pressure will intensify if News Corp's bid to take full control of British Sky Broadcasting cannot be completed.

Crisis costs family in paper losses

Shares

By Robin Wigglesworth in London and David Gelles in New York

The News of the World phone-hacking scandal has so far cost proprietor Rupert Murdoch and his family about $750m in paper losses as the crisis weighs on their shares in News Corp, the shut UK newspaper's ultimate owner.

The media conglomerate's equity – listed in New York and Australia – is split into class A and class B shares, of which only the latter have full voting rights and trade at a slight premium. Despite a mild recovery on Tuesday thanks to a $5bn share buy-back announcement, News Corp has shed about $7bn of its market capitalisation since July 5.

The Murdoch Family Trust, established by Mr Murdoch to keep control of the company within his family, owns 306.6m, or 38.4 per cent, of class B shares. By mid-morning in New York on Tuesday the value of these shares had dropped by $733m to $4.9bn over the past week.

The dual-class stock structure is designed to give the Murdoch family control over the company without it owning an outright majority of shares. It is a popular arrangement in media and technology companies that leaves public market investors with little power.

"Your economic interest is not related to your actual control," said Charles Elson, professor of corporate governance at the University of Delaware. "Here it's an issue of competency. No matter how problematic the managers' conduct, you have no recourse for action."

Alwaleed bin Talal, the Saudi prince, is the company's second-largest voting shareholder and a close Murdoch ally, with a 7 per cent stake, according to Bloomberg data. Rupert Murdoch owns 4.01m class A shares, which have lost more than $10m in value. James Murdoch, head of News Corp's European operations and his father's presumptive successor as head of the group, owns almost 1m non-voting shares, the value of which slipped by about $2.5m by mid-morning in New York.

The family trust owns a further 57,000 non-voting shares, while Lachlan Murdoch, Rupert's eldest son and a former frontrunner to take over the company, owns only 456 non-voting shares, according to Bloomberg data. Lachlan and James also own a few voting shares, data show.

Mr Elson said the dual-class structure made it difficult for shareholders to hold the company accountable for mismanagement. "The question is if [Mr Murdoch] discovered that he acted improperly, would he vote himself out?" he said. "The answer is no."

Murdoch's media empire

News Corp revenue
Figure in brackets shows operating profit/loss year to end Jun 2010

Sources: company; FT research

* Total for News Group Newspapers and Times Newspapers, converted to $

News Corp board

Rupert Murdoch
(Left) The patriarch, architect, chairman and chief executive of the News Corp empire
2010 Compensation: **$22,725,275**

James Murdoch
Murdoch's second son and presumed successor, now deputy COO
Joined Board: 2007
2010 Compensation: **$10,296,081**

Chase Carey
News Corp chief operating officer and a candidate to succeed Mr Murdoch as CEO if James bypassed
Joined Board: 1996 – 2007, 2009 - present
2010 Compensation: **$26,038,482**

Lachlan Murdoch
Murdoch's eldest son, now running private investment company in Australia
Joined Board: 1996
2010 Compensation: **$1,791,000**

José Maria Aznar
Former prime minister of Spain. Joined Board: 2006
2010 Compensation: **$220,000**

Natalie Bancroft
An opera singer who joined the board after News Corp's takeover of her family's company, Dow Jones.
Joined Board: 2007
2010 Compensation: **$220,000**

Peter Barnes
Former executive at cigarette maker Altria. Joined Board: 2004
2010 Compensation: **$236,000**

Kenneth Cowley
Longtime News Corp executive. Joined Board: 1979
2010 Compensation: **$231,000**

David DeVoe
News Corp chief financial officer. Joined Board: 1990
2010 Compensation: **$7,129,429**

Viet Dinh
Former US assistant attorney general. Joined Board: 2004
2010 Compensation: **$258,000**

Sir Rod Eddington
Former chief of British Airways. Joined Board: 1999
2010 Compensation: **$274,000**

Joel Klein
Former head of New York schools now running News Corp's education division. Joined Board: 2010
2010 Compensation: n.a.

Andrew Knight
Longtime News Corp executive. Joined Board: 1991
2010 Compensation: **$281,000**

Thomas Perkins
Legendary venture capitalist. Joined Board: 1996
2010 Compensation: **$258,000**

Arthur Siskind
General counsel for 20 years. Joined Board: 1991
2010 Compensation: **$3,716,365**

John Thornton
Professor and Director of Global Leadership Tsinghua University of Beijing. Joined Board: 2004
2010 Compensation: **$242,000**

Scandal raises questions of spin-off

Investment plans

Possible divestment of UK arm is likely to be discussed, write Salamander Davoudi and Anousha Sakoui

The possible divestment by News Corp of its troubled UK newspaper division News International will almost certainly be discussed, although there is no firm plan for a sale, according to bankers familiar with the media group run by Rupert Murdoch.

"I suspect they must be thinking about it but there is no concrete plan," said a media banker close to News Corp.

The phone-hacking scandal engulfing Mr Murdoch's UK arm has spread beyond the now-closed News of the World to two of News International's other papers – The Sun and The Sunday Times, raising questions about how many News Corp investors would want it to sell the besmirched print business. In the event that News Corp decides to rid itself of the titles, which also include The Times, its options would include a fire sale to a new owner, spinning them off into a separate company, or selling them to Rupert Murdoch or to the Murdoch family trusts.

"News Corp could spin off News International to its existing shareholders and create a separate company," one media banker said. "A spin-off is much more credible because shareholders then benefit from owning a separately listed company rather than trying to sell it for cash."

Any move by the Murdoch family to reduce News Corp's newspaper business would be welcomed by many investors who have long seen the company's "old media" exposure as a drag on its valuation.

Douglas McCabe, analyst at Enders, said a likely option would be to put The Times and Sunday Times, which together lose about £1m a week, into a family trust, effectively removing the titles from News Corp accounts. "It is a way of saying we are going to treat this as a charity and not in straightforward commercial terms."

This could be similar to Guardian Media Group, publisher of the Guardian, which is owned by the Scott Trust, a not-for-profit body that exists to secure the paper's financial and editorial independence.

In 2009, Mr Murdoch rejected a £1bn offer for News International from Richard Desmond, the publisher of the Daily Express.

"Rupert said he didn't want to sell, but he acknowledged it was a good offer," Mr Desmond said in a Guardian interview a year later.

Alexander Lebedev, the Russian billionaire, recently bought the lossmaking titles the Evening Standard and the Independent for £1 each, and has publicly said he wants to buy more media assets.

Yet bankers were sceptical that papers losing millions of pounds could be sold, even to a billionaire seeking a trophy asset. "Newspapers are a declining business. You have to be very rich to put up with those losses. Even Alexander Lebedev could not afford that," said one.

Panmure Gordon has estimated News International could fetch about £300m. The Sun generates about £70m of pre-tax profits annually compared with losses of £42.3m in the year to June 2010 at The Times and Sunday Times.

"I would be amazed if they got more than £300m," said one analyst.

"They can chuck The Times and Sunday Times in a trust and sell The Sun. A non-Murdoch-owned Sun may have real value in the current climate."

If Mr Murdoch's ultimate aim is to secure full control of the highly profitable BSkyB satellite operation, however, any such entity would need to be sufficiently distanced from News Corp to satisfy regulators questioning whether he has too much control over UK media.

Additional reporting by Helen Thomas

News and views inside and at ft.com

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● **Westminster blog**
As-it-happens coverage of parliament's phone-hacking hearing as MPs questioned senior members of London's Metropolitan police service
www.ft.com/westminster

● **The scandal in-depth**
News, comment and analysis of the allegations faced by The News of the World and News International
www.ft.com/phonehacking

● **Hacking timeline**
Pictures and commentary of events in the News of the World phone-hacking scandal, from the appointment of Rebekah Wade (now Brooks) as editor in 2000 to the collapse of the newspaper and the current inquiry
www.ft.com/notw-timeline

● **Slideshow**
Established in 1843, the News of the World was the paper that first launched Rupert Murdoch on to the UK media stage when he acquired it in 1969 after a fierce bidding war with Robert Maxwell. This slideshow looks at the history of the newspaper from its birth to its final edition last week
www.ft.com/notw

● **Video**
End of the Murdoch era? Vincent Boland and Sarah O'Connor on the closure of the News of the World
www.ft.com/notw

● **Media in-depth**
A round-up of the latest news and comment from the industry
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FINANCIAL TIMES

"Without fear and without favour"

Wednesday July 13 2011 4

Eurozone wildfire reaches Rome

Italy and monetary union have no excuse for delay

The battle plan for the eurozone debt market has been to ringfence the smaller peripheral countries to avoid contagion to Spain – and its further spread from there, in the nightmare scenario. Events have now blown that battle plan out of the water. Panicked markets, it turns out, see no need for an Iberian stopover before a direct attack on Italy – the single currency's third-largest economy with its second heaviest public debt burden. The crisis has suddenly turned a whole lot scarier – but not yet scary enough to shake Europe's leaders out of their complacency.

Up until Monday, Italy's cost of borrowing were soaring. Spreads over German bunds reached 3 percentage points, a euro-era record, before coming down a little. Investors across all markets took fright; none more than shareholders of Italian banks, whose equity values plunged by as much as a third.

Markets' nerves were already frayed by still-inconclusive debates on how to solve Greece's financing problem. But Italy is not just a victim of market contagion, in spite of a reputation for relative fiscal probity. It was the height of irresponsibility to sow doubt on the passage of an austerity budget, let alone to make it hostage to prime minister Silvio Berlusconi's business interests.

Rome's blame for where it now finds itself has a long pedigree. It is true that its deficit is smaller than most of its partners', and was admirably controlled during the crisis. But under Mr Berlusconi, Italy eroded a primary surplus which reached 5.5 per cent of gross domestic product in 2000. Like peripheral states now at the mercy of external aid, Italy wasted the windfall from low interest rates in the euro's first decade without creating sustainable growth.

As a result, the debt-to-GDP ratio never fell below 100 per cent and is now about 120. That makes for an explosive debt dynamic: any rise in sovereign yields is amplified in its effect on interest costs. The sustainability of the debt is correspondingly precarious: if buyers of Italian government debt demand a higher risk premium, a vicious spiral could easily be set off.

This outcome can yet be avoided; it would in any case unfold gradually as Rome refinances its debt over time. But there is no excuse for postponing what needs to be done: the austerity budget must be passed now. This has a chance of calming markets. Their worries about Italy may still be mostly derivative: self-fulfilling fears of contagion from Greece. It is in Italy's – and all of Europe's – vital interest that markets not lose confidence in Rome in its own right.

That still leaves the Greek situation unsolved. The signs are not good: in a testament to their complacency, some leaders doubt that a solution can be put in place until parliaments return from summer breaks. At least the Italian scare has put back on the table policies that had been wrongly discarded. Chief among these are voluntary

It was the height of irresponsibility to sow doubt on the passage of an austerity budget

buy-backs designed to capture the market discount to reduce Athens' debt burden. The Financial Times advocates a Brady plan by which investors would swap Greek bonds into new ones that lighten the payment schedule but enjoy eurozone-guaranteed collateral.

The mechanics matter, but what matters most is the principle. The eurozone must explicitly commit to what it still dares not tell voters: it is moving toward guarantees on the periphery's entire public debt. This price must be paid to get markets started again. In return it is possible to capture, for taxpayers' benefit, the discounts already implicit in market prices – a true private sector participation. With the incentive of collateral, the devastating consequences of forced haircuts could be avoided.

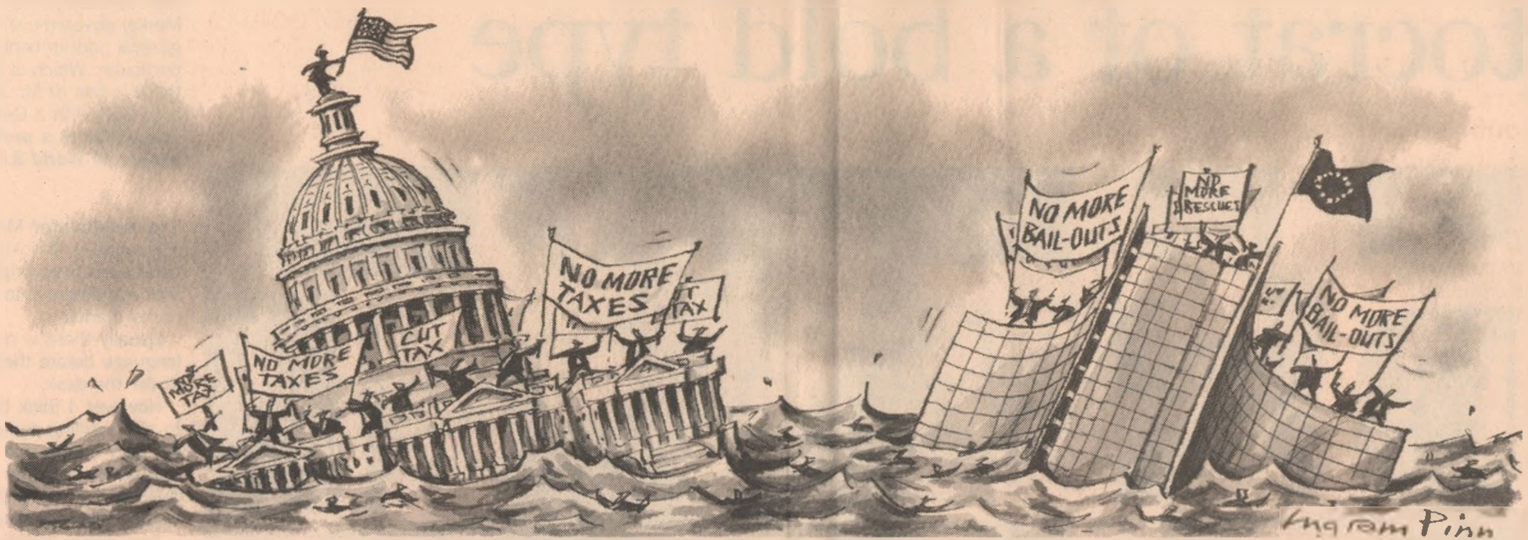
Banks and several capitals are warming to such solutions. Resistance remains – most crucially in Berlin. It must be overcome: history does not look kindly on those who fiddle while Rome burns.

From Italy to the US utopia vs reality

Martin Wolf

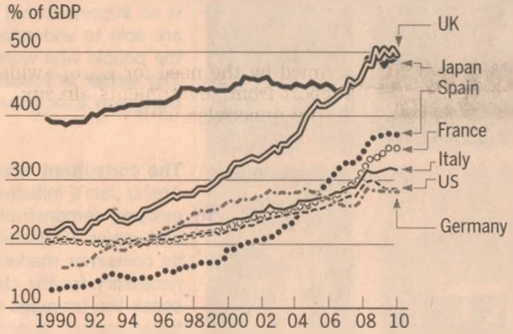
In the eurozone, the fiscal crisis is lapping on Italy's shores. In the US, the administration declares it will run out of funding early next month if the debt ceiling is not raised. Far fewer Europeans than Americans believe public sector defaults are beneficial. But important Europeans share with Republicans the view that there are still worse outcomes. For reluctant Europeans, the eurozone must not be a "transfer union". For recalcitrant Republicans, taxes must not be raised. *Fiat justitia, et pereat mundus* – let right be done even if the world perishes – is the motto.

The fiscal crises we see are a legacy of the west's private and public sector debt binges of recent decades. As the McKinsey Global Institute tells us in an update of last year's study of the aftermath of the credit bubble, this is an early stage of a painful process of deleveraging in several economies (see chart).* "If history is a guide," noted the 2010 report, "we would expect many years of debt reduction in specific sectors of some of the world's largest economies, and this process will exert a significant drag on GDP growth." So it is proving, with disappointment almost everywhere.



Domestic, private and public sector debt

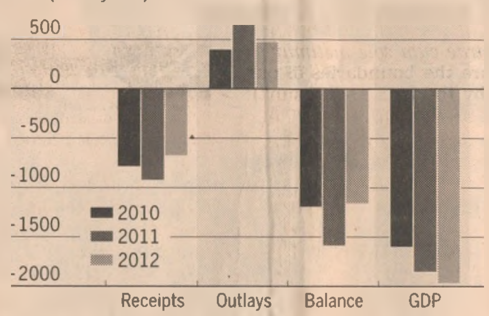
% of GDP



Sources: McKinsey; FTResearch; Thomson Reuters Datastream

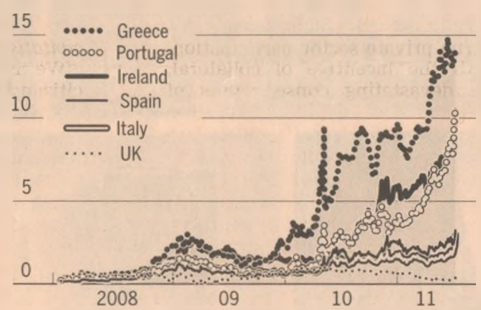
Difference between US 2008 and 2012 budgets

$bn (fiscal years)



10-year bond spreads over Bund

% points



The link between private and public sector debt is intimate. In some countries, notably Greece, easy credit led to an upsurge in public sector borrowing. In others, notably Italy, it encouraged governments to relax attention to debt reduction: its primary fiscal budget (before interest) moved from a surplus of 6 per cent of gross domestic product in 1997, before joining the currency union, to 0.6 per cent in 2005. Elsewhere, the sudden end of private sector credit booms led directly to collapses in government revenue and surges in public spending: the US, UK, Spain and Ireland are examples.

Exploding fiscal deficits are mainly the result of collapses in activity and revenue rather than of bank bail-outs. But fiscal weakness then undermines the banks, partly because the latter hold large quantities of domestic public debt and partly because they rely on fiscal support. The private and public sectors are intertwined. The view of Republican hawks in the US and of German or Dutch hawks in Europe that the crisis has fiscal roots alone is wrong. Easy credit ends up in fiscal crises.

US evidence is striking. Compare the forecasts for fiscal years 2010, 2011 and 2012 in the 2008 and 2012 presidential budgets, the first under George W. Bush shortly before the crisis and the second under Barack Obama well after it (see chart). The 2011 deficit was forecast in 2008 to be a mere $54bn (0.3 per cent of GDP). But in the 2012 budget, it is forecast to be $1,645bn (10.9 per cent of GDP). 58 per cent of this rise is due to unexpectedly low revenue and only 42 per cent due to a surge in spending, both of these changes mostly due to the financial crisis, not the modest stimulus package (about 6 per cent of GDP).

The astonishing feature of the federal fiscal position is that revenues are forecast to be a mere 14.4 per cent of GDP in 2011, far below their postwar average of close to 18 per cent. Individual income tax is forecast to be a mere 6.3 per cent of GDP in 2011. This non-American cannot understand what the fuss is about: in 1988, at the end of Ronald Reagan's term, receipts were 18.2 per cent of GDP. Tax revenue has to rise substantially if the deficit is to close.

It is not that tackling the US fiscal position is urgent. At a time of private sector deleveraging, it is helpful. The US is able to borrow on easy terms, with yields on 10-year bonds close to 3 per cent, as the few non-hysterics predicted. The fiscal challenge is long term, not immediate. A decision not to allow the government to borrow to finance the programmes Congress has already mandated would be insane. As the fiscal expert, Bruce Bartlett, has argued, the law requiring Congressional approval of extra debt might even be unconstitutional.

Yet, astonishingly, many of the Republicans opposed to raising the US debt ceiling do not merely wish to curb federal spending: they enthusiastically desire a default. Either they have no idea how profound would be the shock to their country's economy and society of a repudiation of debt legally contracted by their state, or they fall into the category of utopian revolutionaries, heedless of all consequences.

Meanwhile in Europe, happily, nobody believes that defaults are good. But Europe is trapped in its own utopian project: the single currency. Just as members of the Tea Party hate paying taxes for those they deem unworthy, so, too, do solvent Europeans hate transfers to those they deem irresponsible.

Alas, as many have long predicted, what would, in the absence of the currency union, have been a straightforward currency crisis has now morphed, within these constraints, into an agonising fiscal cum financial crisis. Worse, spreads on Spanish and Italian 10-year bonds over German bunds have reached 328 and 296 basis points, respectively.

In slow-growing economies with overvalued real exchange rates, these spreads begin to be dangerous. If they became and remained, say, 400 basis points, the real interest rate on long-term debt would be 5 per cent. These countries would then be slowly shifted from a good equilibrium, with manageable debt, to a bad equilibrium, with close to unmanageable debt. Italy, with the fourth-largest public debt in the world, is probably too big to save: Italians themselves must make the decisive moves needed to restore fiscal credibility. That, in turn, requires both a sharp tightening and measures to raise the growth rate. Can this combination be managed? Only with difficulty, is the answer.

These are dangerous times. The US may be on the verge of making among the biggest and least-necessary financial mistakes in world history. The eurozone might be on the verge of a fiscal cum financial crisis that destroys not just the solvency of important countries but even the currency union and, at worst, much of the European project. These times require wisdom and courage among those in charge of our affairs. In the US, utopians of the right are seeking to smash the state that emerged from the 1930s and the second world war. In Europe, politicians are dealing with the legacy of a utopian project which requires a degree of solidarity that their peoples do not feel. How will these clashes between utopia and reality end? In late August, when I return from my break, we may know at least some of the answers.

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civil servants less culpable, than appeared at the time.

The Crichel Down affair was a classic affirmation of the principle of ministerial accountability: ministers are responsible for what happens in their department regardless of whether they authorised it. Sir Thomas acknowledged this doctrine in his resignation speech, saying: "I, as minister, must accept full responsibility for any mistakes and inefficiencies of officials in my department just as, when my officials bring off successes on my behalf, I take full credit for them".

Arnold Weinstock, for many years chief executive of Britain's General Electric Company, gave an eloquent exposition of the nature of personal responsibility in business in a letter sent to managers of English Electric when GEC acquired that company in 1968. English Electric was mired in bureaucracy that Weinstock was determined to stamp out.

The extensive use of meetings, the compilation of long lists of people copied into every communication, creates an environment in which there is no personal commitment to any course of action, and everyone feels relieved of obligation to acquire

Ministerial accountability has been replaced by T.S. Eliot's cat: 'When a crime's discovered, then Macavity's not there'

the knowledge to judge effectively. Weinstock's missive announced the abolition of all internal committees. Managers would be given personal responsibilities for tasks. They would be permitted, even encouraged, to delegate these tasks and to involve colleagues in their decisions: but these actions would never reduce or remove their personal responsibility.

Good organisations maintain this approach. Apple's successes and failures are closely associated with the company's founder. But Steve Jobs cannot do it all himself. His managerial style emphasises the role of the "directly responsible individual" – someone accountable for each new activity and project.

Such a culture is sustainable only in an organisation that allows individuals to make mistakes and encourages them to recognise them. We all know hopeless organisations in which attention is devoted, not to making things go right, but to attaching oneself to projects that are going well and distancing oneself from those that are not. Apple has got many things wrong but succeeds because a few of its many initiatives have been transforming innovations.

It is hard to determine when the principle of ministerial accountability died. But by the time Stephen Byers could slip from one cabinet post to another without taking responsibility for any of the blunders that seemed to happen wherever he was in charge, ministerial accountability