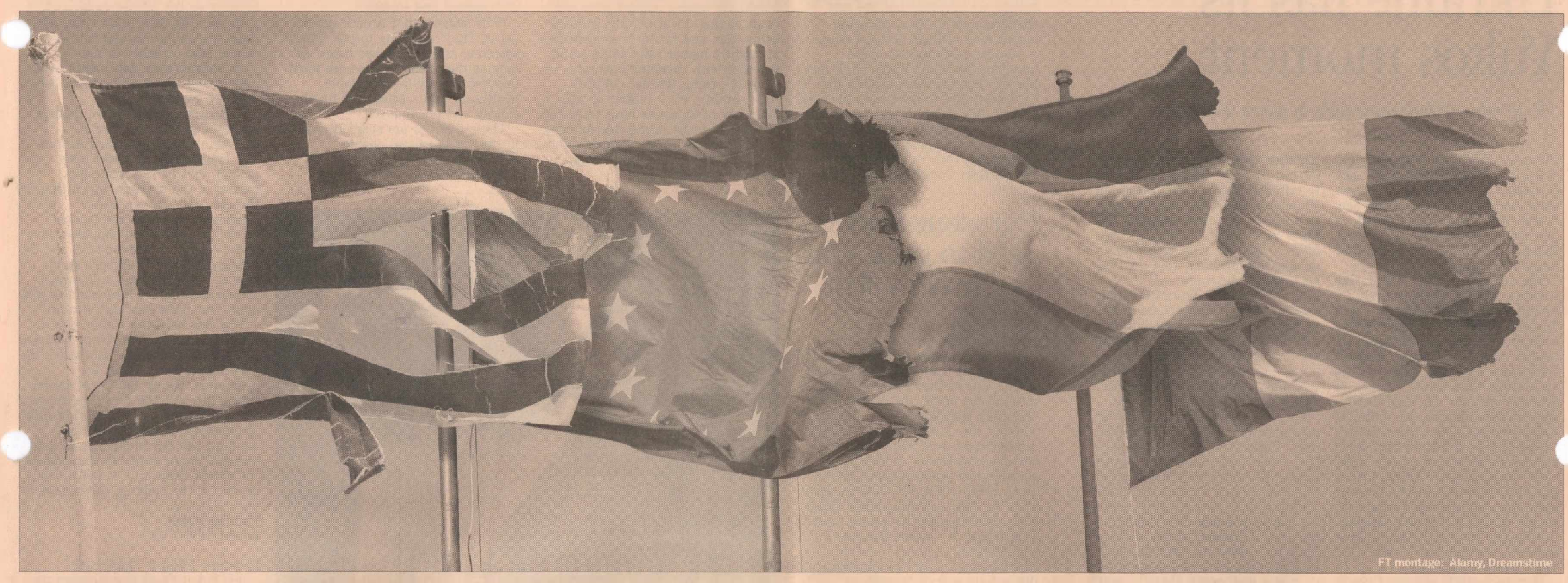
An elusive debt resolution

Eurozone The quest for a second Greek bail-out is beset by conflict and confusion, writes **Peter Spiegel**



FT montage: Alamy, Dreamstime

As recently as a month ago, it appeared that a second bail-out of Greece would be a relatively straightforward affair. As with previous rescues cobbled together by the European Union and its lending partner, the International Monetary Fund, staff economists would estimate Athens' financing hole over the next three years (about €115bn), agree a reform programme with the government and start writing cheques.

But instead, European leaders have been drawn into one of the most agonised debates seen since the eurozone debt crisis erupted nearly two years ago. It has sowed confusion in financial markets and pushed borrowing costs for the third-and fourth-largest eurozone economies – Italy and Spain – to 6 per cent, levels some analysts believe are not sustainable.

The confusion stems from the interlocking, and sometimes conflicting, problems facing European leaders.

Greece's debt burden – expected to hit 172 per cent of gross domestic product next year – is, for example, so large that it may never get paid. Officials cannot acknowledge this, however, for fear of spooking bondholders into believing default is at hand. Similarly, private investors face political pressure to bear the burden of a new bail-out – but among the largest investors in Greek bonds are Greek banks, which would take huge losses (and need more international aid) if their holdings were cut in value.

"Every time we resolve one issue, two more come up," says a senior European official involved in the deliberations.

The conflicting problems are compounded by conflicting institutions. Almost every participant in the debate – Athens, the European Central Bank, the IMF, the European Commission and national capitals – holds different and sometimes mutually exclusive interests.

The Frankfurt-based ECB, for instance, is responsible for making sure Europe's banking sector remains solvent. But the sector (as well as the ECB itself) holds vast quantities of peripheral bonds – meaning any undermining of their value could hit their capitalisation levels, limiting their ability to survive a Lehman-like collapse. The German government, on the other hand, under pressure from the Bundestag, wants some of those banks to accept less than they were originally promised for their bond investments.

The result: Frankfurt and Berlin are at – increasingly tetchy – cross purposes. Can the square be circled? Officials say if it was easy to do, it would have been done by now.

There is intense pressure on the Germans and the Dutch to drop their insistence that bondholders pay a price, a stance that has held up an agreement and led to most of the market panic. But Berlin and the Hague argue that without bondholder participation a new deal will not be credible, since it will not lower Greece's overall debt burden.

Around and around it goes. With just a day to go before an emergency summit in Brussels on Thursday, European officials say they will get a deal done in time. "There needs to be a very clear political agreement on all the elements," says the European official. However, the battle to determine the exact nature of that deal will go right to the wire.

Problem 1
The first rescue package was not big enough

Solution European leaders have agreed in principle to a second bail-out, needed to fill an estimated €115bn hole in Greece's budget during the next three years.

The first package was too optimistic, particularly on Athens' ability to return to financial markets to raise money for government operations. Under the current plan, agreed in May last year, Athens was supposed to raise €10.9bn in long-term loans from the bond market in March 2012, and €44.1bn between mid-2011 and mid-2013. With Greek 10-year bonds currently trading with interest rates above 18 per cent, officials have been forced to accept that this is impossible. More bail-out money is needed to fill the gap.

Players Behind the drive for a new bail-out is the International Monetary Fund, whose rules prevent it disbursing aid to a country without ensuring it has all the cash it needs for the next 12 months.

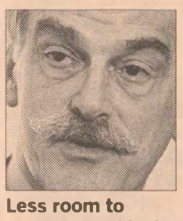
Dominique Strauss-Kahn's resignation as IMF chief in May complicated matters. Officials say he had indicated he would be more lenient towards the European Union, and would not require it to quickly agree a new bail-out. But John Lipsky, who as IMF interim head had less political room to manoeuvre, pushed hard for a concrete new plan. George Papandreou, Greek prime minister, formally requested another bail-out late last month.

While the eurozone portion of the current bail-out is funded by loans directly from individual countries, the current and new packages are likely to be combined into a single IMF-EU programme totalling as much as €170bn – with the eurozone contribution coming from the European Financial Stability Facility, the €440bn bail-out fund.

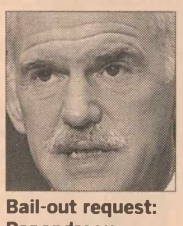
In a hole

Greek bail-out requirements* (€bn)

Sources: EC; IMF * Estimates



Less room to manoeuvre: Lipsky



Bail-out request: Papandreou

Bail-out fund: EFSF

Problem 2
German, Dutch and Finnish voters are against funding another bail-out

Solution Leaders in all three countries have pushed for private holders of Greek bonds, mostly European banks, to shoulder part of a second bail-out. The original idea, proposed by Germany, was to persuade them to accept a delay in repayment on the €85bn worth of debt due in the next three years.

A more detailed version of this plan, again backed by Germany, would offer bondholders the chance to swap current holdings for new bonds not due for another seven years. Despite the "voluntary" nature of the plan, rating agencies threatened to rule it a "selective default", as investors would not receive their full returns and officials would probably rely on coercion to win broad participation.

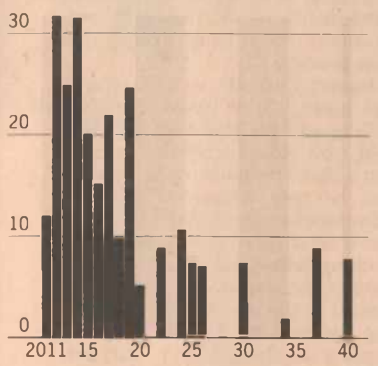
Attention then shifted to a less onerous French-backed alternative, where banks would agree to invest in new Greek bonds as soon as their holdings matured. But rating agencies ruled that this plan would also constitute a default, which sent negotiators for the EU and the banks back to the drawing board.

Players Pressure for private bondholder participation has been led by Wolfgang Schäuble, German finance minister, and Jan Kees de Jager, his Dutch counterpart. Both governments have promised their parliaments "significant" and "quantifiable" bondholder commitments, despite pressure from bodies such as the European Central Bank to drop the demand.

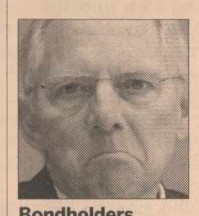
Leading negotiators for the banks is Charles Dallara, managing director of the Institute of International Finance. In a policy document given to EU leaders last week, he put the French and German plans on a list of possible tacks to which the banks would agree.

Mind the gaps

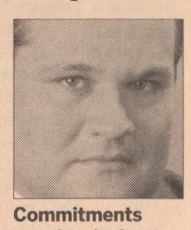
Greek debt due for repayment (€bn)



Source: Re-Define



Bondholders beware: Schäuble



Commitments sought: de Jager

Lead negotiator: Dallara

Problem 3
Greek banks being dragged under by the debt crisis may also lose emergency funding

Solution Highlighting the dual nature of the problem, European officials are working on a two-pronged approach. First, they are trying to tailor the bail-out so that any cut-off of European Central Bank funding would be temporary. They are also discussing plans to inject capital into Greek banks.

The most immediate threat is of a Greek default on its bonds, which would trigger an ECB cut-off. For months Greek banks have relied on the ECB for low-cost loans to run day-to-day operations. But the ECB requires "adequate" collateral – and the banks' primary form of collateral is Greek bonds, which would be nearly worthless if they were in default. Eurozone officials are looking for ways to conjure up to €20bn in guarantees to enable continued borrowing from the ECB. Alternatively, the ECB may allow the Greek central bank, headed by George Provopoulos, to provide emergency loans.

A default would also probably force international lenders to recapitalise Greek banks as one of their other large sources of capital – Greek debt – would be significantly devalued.

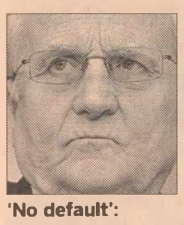
Players Jean-Claude Trichet, ECB president, has driven this debate with his no-default stand. Others on the ECB's governing council have been yet more adamant, since there are signs Mr Trichet could relent if even one of the major rating agencies decides against declaring default on whichever plan is adopted.

All Greek banks would probably need a capital injection if there were a bond default but those with particularly large holdings include National Bank of Greece, with a total of €12.9bn; EFG Europank, with €8.7bn; and Piraeus, with €8.1bn.

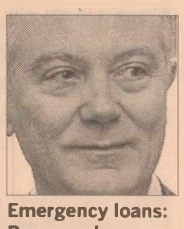
A slow run

...tal deposits in Greek banking system, excluding Bank of Greece (annual % change)

Source: Bank of Greece



'No default': Trichet



Emergency loans: Provopoulos

Capital needs: Greek banks

Problem 4
Fears of a Greek bond default have led to a run on Spanish and Italian bonds

Solution Officials will emphasise that the plan to involve private shareholders in a Greek bail-out is aimed at Athens alone. But it could prove tough to convince investors.

To be fair, some of the panic in Italy is self-inflicted, with prime minister Silvio Berlusconi choosing exactly the wrong moment to pick a public fight with Giulio Tremonti, his respected finance minister. But Spain has been hit hard by "contagion" despite its exemplary implementation of reforms, its spending cuts and the overhaul of its banking system.

The cause of investor concern is the debate over Greece. If European leaders have reached the point at which they are actively considering defaults and debt restructurings for Greece, what is to stop them doing the same for Ireland and Portugal – which have also been bailed out – or for Italy and Spain? Moody's, the rating agency, stated when it recently downgraded Irish and Portuguese debt that the shift in European attitudes towards defaults was a primary motivator in their decision.

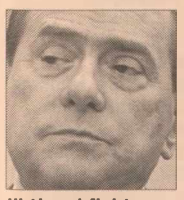
Players Moody's and the other leading rating agencies, Fitch and Standard & Poor's, will play a significant role in deciding whether EU efforts to convince markets private bondholder participation is limited to Greece is credible.

Italian and Spanish officials believe they have done as much as they can to reassure investors – including rushing through a €47bn Italian austerity programme in recent days – and are hoping a quick decision on the specifics of a Greek bail-out at the Brussels summit on Thursday will end the assault on their sovereign bonds. Mr Berlusconi's spat with Mr Tremonti continues to cause concern, however.

It's catching

Italian and Spanish 10-year bond yields (%)

Source: Thomson Reuters Datastream



Ill-timed fight: Berlusconi

Respected: Tremonti

Significant: rating agencies

Problem 5
Athens' debt burden is potentially too big to be paid off

Solution The overall Greek debt burden stands at €350bn. The most significant new suggestion for reducing it is to use the European Financial Stability Fund to finance a large bond buy-back plan – a scheme that could also be adopted by Ireland and Portugal. Although the EFSF does not have the power to conduct such a plan, it could lend Greece the funds to make the purchases itself.

Because Greek debt currently trades significantly below face value, investors would take a "voluntary" loss when selling their bonds in a buy-back – but would at least receive something for their investment. In return, Athens would retire the bonds and cut its debt burden. As Greek bonds are now trading at about 60 per cent of face value, a €30bn buy-back programme could wipe €50bn of the balance sheet.

Germany, which has long resisted this plan, looks ready to concede. It also looks more conciliatory on another point: lowering the rates Ireland, Portugal and Greece pay on their EFSF bail-out loans. Originally, all bailed out countries had to pay 300 basis points above the EFSF's cost of borrowing, a punitive rate meant to discourage bail-outs.

Players Mr Trichet has been pushing to use the EFSF for bond buy-backs, and has supporters within the European Commission, especially Olli Rehn, the EU's most senior economic official. Mr Rehn, backed by José Manuel Barroso, commission president, is also a prime advocate for lower interest rates.

Angela Merkel, German chancellor, and Mark Rutte, Dutch prime minister, would be making a significant climbdown if they backed the bond-buying scheme since they fiercely resisted it six months ago.

Exposed to Athens

European bank exposure to Greek sovereign debt*

Source: EBA * Top 10 excluding Greek banks

Ready to concede?: Merkel

Climbdown option: Rutte

Rate reduction: Rehn

FINANCIAL TIMES

"Without fear and without favour"

Wednesday July 20 2011

Ukraine has its Yukos moment

The EU should link trade talks to Kiev's democratic record

Ukraine's president Viktor Yanukovich has justifiably been accused of setting up a "Putin lite" system since his election 18 months ago. Power has been concentrated in his hands, media criticism stifled. Extending the analogy, he has now found his Yukos case.

The accused in Kiev is not, like Russia's Mikhail Khodorkovsky, a billionaire oligarch. She is Yulia Tymoshenko, the former prime minister and Orange revolution co-leader. As in Russia, few in Ukrainian business and politics are whiter than white; shades of grey abound. So the legal assault on Ms Tymoshenko, as with Mr Khodorkovsky, looks like selective justice and a politically-motivated attempt to neutralise an opponent.

Mr Yanukovich's camp insists that the action is part of a broader corruption clampdown, probing 400 as yet unnamed current officials. Yet nearly all of the high-ranking figures charged to date are Tymoshenko associates.

Moreover, while she faces proliferating investigations, the charge on which Ms Tymoshenko is on trial – carrying a potential 10-year sentence – is highly questionable. She is accused of exceeding her authority in agreeing a 2009 gas deal with Russia's Vladimir Putin at an excessively high price.

This raises questions over whether policy steps, particularly during a crisis, should be subject to criminal charges. The European Union welcomed the deal in question as it restored Russian gas flows to Ukraine and further west after a shut-off, and removed an opaque intermediary from the Russia-Ukraine gas trade.

Faced with western criticism, Mr Yanukovich's circle is rumoured to be seeking a face-saving solution – say, a suspended sentence, keeping Ms Tymoshenko out of jail but also out of the next elections. The international community should reject that kind of cynical manoeuvre.

For the EU, in particular, has far greater leverage over Ukraine than over Russia. It is negotiating a free trade and association agreement with Kiev. EU officials seem reluctant to link the talks with Mr Yanukovich's democratic record for fear of pushing Kiev back into the arms of Russia, which is trying hard to restore its influence over Ukraine. Yet Kiev has made clear it wants and needs the EU deal, calling closer European integration Ukraine's "strategic choice".

That gives Brussels power it should use – to suspend talks if the assault on Ms Tymoshenko continues. Trade privileges should be linked to values. And the values displayed in this case fall far short of those demanded by the EU.

Murdochs at bay

Parliament exposes the weaknesses in the News Corp case

The appearance of Rupert and James Murdoch before the House of Commons media select committee was more than a piece of theatre. Over three hours, including an enforced break after a custard pie attack, MPs and the watching world were treated to a rare insight into the management of the Murdoch empire.

The hearing exposed the extent to which Rupert Murdoch and his heir apparent were unable or unwilling to account for criminal behaviour at News Corp's British newspaper subsidiary, specifically the phone-hacking scandal which has convulsed the nation.

While expressing contrition, Rupert Murdoch exonerated all the senior executives who ran the UK business during the relevant period, including Rebekah Brooks, her predecessor, Les Hinton, and James Murdoch himself.

It remains unclear, therefore, to whom Rupert Murdoch was referring when he said the company had been badly betrayed in connection with the hacking. This is a question that will at some point need to be answered, either in the judge-led inquiry ordered by the prime minister or the renewed police investigation.

Select committee hearings have in the past sometimes been ineffective because of the inability of MPs to focus on a coherent line of inquiry. This one was a great improvement, with members having the time and space to develop forensic lines of questioning.

Much of the session was rightly devoted to the question of corporate governance. Mr Murdoch painted a picture of media mogul content to hand authority to those running the outer reaches of his empire. But this case study in devolution apparently ended up with no one taking responsibility. This despite long-running payments to convicted felons and confidential settlements with potential witnesses to the tune of several million pounds.

Rupert Murdoch pointed out that the News of the World, the best-selling and profitable Sunday tabloid, now closed after 168 years, is but a small fragment of his empire. Yet he now recognises that his newspaper fundamentally breached the trust of its readers. James Murdoch presented himself as the prisoner of decisions taken prior to his arrival at the UK business concerning the hacking scandal – merely signing off cheques and court settlements at the behest of lawyers.

This will not do. The company has not explained how a culture of lawlessness was allowed to take hold. The Murdochs still have questions to answer.

Nuclear drift

Japanese government must restart or replace its reactors

As it struggles to resolve the worst nuclear crisis in a quarter of a century, Japan faces hard policy choices that will have far-reaching implications for the world's third-largest economy. In the longer term, it must decide what role atomic energy should play in powering an archipelago that lacks oil, coal and gas reserves, and is worryingly seismically active. More immediately, it must either bring many of the nation's currently idled reactors back online or find ways to minimise the economic damage that could be caused by resulting capacity shortfalls.

Unfortunately, the Democratic party-led government has failed to address either issue convincingly. After weeks of frantic efforts to stave off disaster at the crippled Fukushima Daiichi power station, Naoto Kan, the prime minister, seems unsurprisingly sceptical about the industry. But his announcement last week that Japan should aim to be a "society that can manage fine without nuclear power" does not have the unambiguous support even of his own cabinet.

Mr Kan has also botched the near-term issue of whether to restart reactors that were offline for routine checks before the March 11 earthquake and tsunami, or shut down when they struck. Well under half of Japan's 54 reactors are currently online, no small matter in a nation where nuclear power usually accounts for nearly a third of electricity generation. But turning them back on requires the consent of local leaders.

Earlier this month, the government appeared close to gaining such backing for two reactors in Genkai, but the process is now in doubt after Mr Kan suddenly announced that even reactors previously declared safe must pass ill-defined "stress tests". With companies in the economically crucial Greater Tokyo and western Kansai regions already being told to cut peak electricity usage by 15 per cent this summer, the administrative chaos is deeply unhelpful. Uncertainty over power supplies can only suppress new business investment and accelerate the flow of industrial capacity overseas.

This is not to say that the government should blindly bow to the nuclear lobby and sign off on all reactor restarts, while abandoning efforts to develop long-term alternatives. An embrace of renewable energy and conservation will also bring business opportunities. But Mr Kan and his colleagues urgently need to minimise uncertainty by at least agreeing among themselves what should be done – and by communicating their decisions in a more convincing way.

Letters

Americans do get it and just want some fairness

From Mr Bartholomew Sparrow.

Sir, Mort Zuckerman ("A bankrupt America needs an age of austerity", July 15) captures some of the oddities of current fiscal debate.

One is amnesia: few Republicans during the Reagan and George W. Bush eras protested against the huge deficits then being rung up. That politics is masquerading as principle should not surprise, but the self-righteousness of those opposing higher debt ceilings perhaps does.

Another is Congress's fiscal irresponsibility: Mr Bush's and, now, Barack Obama's wars are the first in US history not to have been paid for, at least in part, with higher taxes.

A third, as Mr Zuckerman notes, is the silence on defence. If no amount of spending can truly make the US secure, then Congress has to make the tough trade-offs between military and non-military spending, and to be prepared to take the scalpel to both defence and non-defence expenditures. Or is defence the new third rail?

Fourth, Mr Zuckerman doubts that new taxes will raise enough money, yet a few corrections to the multiple (and ample) tax breaks and loopholes, raising capital gains tax rates, taxing unearned inheritances below $5m and taxing the wealthiest at slightly higher rates taxes could, together with spending cuts, put things to right. It's not political impossibility; it's a matter of will. Members of Congress have to be the adults and insist on no free lunches.

Finally, the Grover Norquists and others who so vehemently resist taxes or even removing discriminatory tax breaks forget that wealth doesn't grow in a vacuum, detached from a society of voters, consumers, investors and taxpayers or from the transport infrastructure, schools, police and other public goods and services state and federal agencies provide.

The wealthiest have prospered precisely because of American government and society.

Polls suggest that Americans do get it. They're willing to cut defence spending and pay higher taxes, as long as they believe taxes are fairly imposed, to pay for affordable healthcare and a safety net for the elderly and unemployed.

These realities are scarcely evident in the current fiscal debate.

Bartholomew Sparrow,
Austin, TX, US

Eurozone leaders need to get a grip on Greece's debt

From Prof David Cameron.

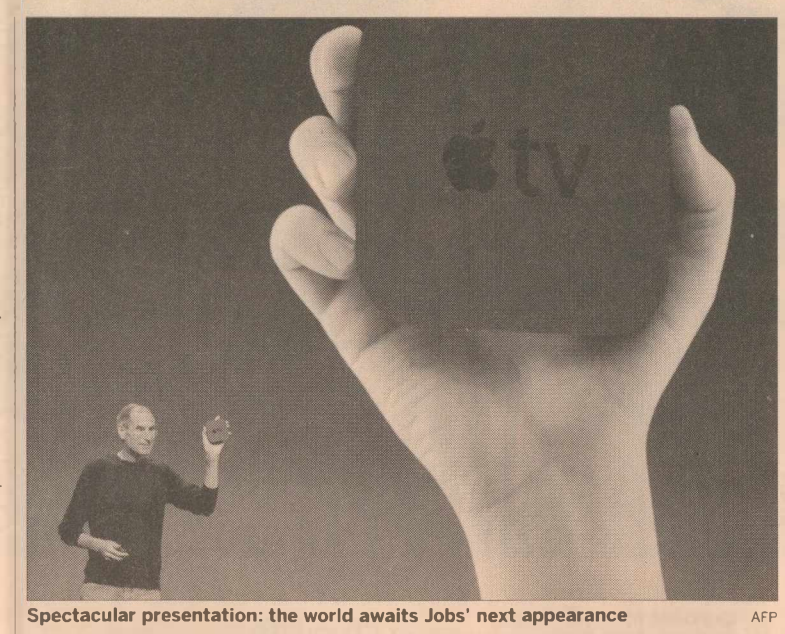
Sir, it is time for the eurozone leaders to stop procrastinating and prevaricating and address the crisis.

Thus far, as they have muddled through the crisis, the leaders have delicately sidestepped the question of whether the Greek debt has to be restructured. It is now painfully obvious that Greece, mired in austerity for years to come, has too much debt, will not be able to repay all of its debt and desperately needs debt relief in order to restore growth. That inevitably means haircuts for bondholders. The only question is whether they occur voluntarily, through an orderly default, or involuntarily, through a disorderly, chaotic and possibly contagious one.

When they meet tomorrow, the heads of state or government of the eurozone should act decisively to restructure and reduce the Greek debt. Between now and mid-2014, about €100bn of the €340bn of Greek debt will reach maturity. The leaders should expand the resources available to the European financial stability facility, authorise it to buy Greek debt that reaches maturity in the next few years at a price below par but above the current price in secondary markets, and replace it with new debt having long terms and low coupons. They should also authorise the EFSF to guarantee the principal of debt held by private bondholders who voluntarily roll over their current holdings into new debt having long terms and low coupons.

That may be costly and may create political difficulties for some leaders. But doing nothing is no longer an option.

David R. Cameron,
Dept of Political Science,
Yale University,
New Haven, CT, US



Spectacular presentation: the world awaits Jobs' next appearance AFP

Jobs knows how to hold his audience

From Mr Robert Kwasny.

Sir, Lucy Kellaway speaks out against using PowerPoint during presentations, claiming that it makes the audience fall asleep, is "the least enjoyable way of wasting time there is", and "lowers the quality of discussion and leads to bad decisions" ("Anti PowerPoint revolutionaries of the world unite", July 18). While I do agree that we have a problem with disappointingly delivered presentations, Ms Kellaway mistakes the symptoms for the causes.

PowerPoint did not gain popularity without reason. It allows the speaker to provide an easy-to-follow outline of the presentation and lets him supplement it with pictures, graphs and charts. Used properly it can have spectacular effects. Steve Jobs uses Keynote (Apple's own presentation software) when he announces new products and services. He bores no one. Just the opposite – the whole world awaits his next appearance.

Clearly, PowerPoint presentations can be delivered in an interesting, engaging and informative way. However, most speakers refuse to take full advantage of its possibilities. They insist on copying reports and written analysis and pasting them on PowerPoint slides.

Creating a good presentation requires planning well what one wants to say, meticulous research, finding appropriate pictures, making the right charts, focusing on details of the design and practising to perfect the timing. There is nothing easy or fast about any of these steps.

There are good and bad PowerPoint speakers just as there are good and bad drivers. We might decrease the number of deaths in car accidents by banning cars altogether, but that is not the point, is it?

Robert Kwasny,
Chojnice, Poland

Brazilian bicycle is still sturdy despite bumps on the road

From Mr Vinicius Licks.

Sir, Brazil's economy is far from halting as you suggest ("Brazil's currency war wounds", Editorial, July 8) through an inspired analogy to a wobbling bicycle. In fact, the country has grown 7 per cent in 2010 and it is expected to grow 4 per cent this year. Fears of a credit bubble are unjustified. Indeed, domestic credit has been expanding fast (18 per cent in 2010) but it currently represents 46 per cent of the gross domestic product, as compared with 70 per cent in Chile, for example. An expanding labour force and real wages growing at 3 per cent in 2010 seem to challenge the perception that this growth rate is unsustainable.

Brazil is expected to hold a current account deficit of 2.5 per cent of gross domestic product this year, which is comparable to the UK's and less than the 3.5 per cent expected of the US economy. Nevertheless, the record high foreign reserves at $340bn are sufficient to cushion that deficit for years to come.

Exports of agricultural commodities have indeed helped to hold back current account deficits, but it would be unfair to attribute this fact only to increasing commodity prices. Increasing productivity has played its role in the expansion of agricultural output and will continue to do so in the foreseeable future. According to official projections, crop production will increase 23 per cent in the next 10 years.

If there is one thing that needs improvement it is the country's sufferable infrastructure and the national savings rate, which has been insufficient to fund investments even at meagre 19 per cent of GDP. That has lead the country to rely on foreign capital to furnish 12 per cent of the investments in 2010.

Increasing savings will depend on the government's will to cut budget expenditures that today represent 28 per cent of GDP, unleashing capital that can otherwise become available to fund investments. But that appears to be the tune around the world.

It seems that the Brazilian bicycle is still running safely after all, despite some bumps along the road.

Vinicius Licks,
Mason Fellow, Harvard Kennedy School of Government,
Cambridge, MA, US

It is the Pompeys who are difficult to pin down

From Mr Paul Rayment.

Sir, It is not inconceivable that the Murdochs, father and son, and Rebekah Brooks, the former editor of the News of the World, knew nothing of the details of telephone hacking or the alleged bribing of policemen by their staff. After all, these are ambitious and ruthless people who, whether or not they read Shakespeare, will instinctively understand the significance of the Pompey precaution.

In *Antony and Cleopatra*, Menas suggests to Pompey, who is entertaining Caesar, Mark Antony and Lepidus on his yacht (aka galley), that he can make him master of the universe by cutting the throats of his three guests.

Pompey groans at the tactical error: "Ah, this thou shoulds't have done, And not spoke on't! In me 'tis villainy; in thee't had been good service . . . Being done unknown, I should have found it afterwards well done, But must condemn it now."

This has been the classic line of unscrupulous leaders down the ages: if the dirty tricks are discovered, the subordinate loses his or her promotion, bonus, job or, in earlier times, life. But the Pompeys, those who create the culture and incentive structures that encourage rule bending and law breaking, are more difficult to pin down. In this respect, the recent behaviour of the tabloid press and the banking sector is not very different.

Paul Rayment,
London SW1, UK

From Mr Edward Lidderdale.

Sir, When I took her through the current travails at the UK's Metropolitan Police, my wife responded with the old Japanese saying "Tada yori takai mono wa nai", which may be loosely rendered as: "There is nothing dearer than a freebie."

Edward Lidderdale,
Morden, Surrey, UK

Balkan connection carries baggage

From Mr Thomas Niles.

Sir, Regarding the use of the word "Balkan" ("Balkan and must", Lex, July 18): it is quite understandable that Greeks are not enamoured of the term. First, "Balkan" is a Turkish word, meaning "mountain", and as such carries with it a reminder of more than 500 years of occupation. Second, it conjures up an image of a poor, dark and dangerous place where wars erupt and innocents are slaughtered.

Far better to use the term "south-eastern Europe", which has none of that negative baggage and has the extra added advantage of geographical accuracy.

Thomas Niles,
Scarsdale, NY, US

Correction

● Laurence Kotlikoff is an economist at Boston University, not Boston College as wrongly stated in an article on July 15.

COMMENT ON FT.COM

The World blog
John Paul Rathbone: revolting middle classes eclipse clash of civilisations
www.ft.com/theworld

Material World blog
Vanessa Friedman: ties that bind the Murdochs in Westminster
www.ft.com/materialworld

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Comment

Little to celebrate on Dodd-Frank's birthday

Hal Scott

America's Dodd-Frank act is one year old on Thursday. The act made some useful corrections in the regulation of American financial markets, but it has failed to respond effectively to the root causes of the financial crisis and its impact on the global financial system. In the short term, it has hindered economic recovery. Worse, in the longer term, it has actually made future crises more likely, while potentially damaging the international competitiveness of America's financial institutions.

The crisis resulted from a housing bubble fuelled by loose monetary policy and excessive risky lending by over leveraged banks, encouraged by pro-housing financial regulation. Yet Dodd-Frank did not rectify the low underwriting standards of Fannie Mae and Freddie Mac, and failed to reverse the low levels of capital that Basel has required banks to hold for mortgages. Its creation of a Financial Stability Oversight Council to monitor systemic risk – a ten-headed hydra of largely independent agencies – will not be effective.

As the crisis developed, plunging housing prices created a contagious liquidity problem, only headed off by heroic policies of the Federal Reserve, the Federal Deposit Insurance Corporation and the US Treasury. Yet Dodd-Frank has now crippled the ability of these same agencies to respond in the same way to future crises. The Fed can no longer lend to individual companies, as it did to AIG. More importantly it can no longer establish emergency liquidity facilities without the written agreement of the secretary of the Treasury, who may in the future be a hostage to America's new "anti-bail-out" consensus.

The FDIC, meanwhile, can no longer guarantee deposits above a new $250,000 limit after the end of 2012, or guarantee senior debt, without a joint resolution of Congress. Due to earlier legislation relating to the financial crisis, the Treasury also can no longer use its economic stabilisation fund to guarantee money market funds. As a result, at a whiff of a new crisis, liquidity will dry up in a flash.

Dodd-Frank did at least insist that systemically important financial institutions hold more capital, while banks hold at least as much capital as required under the original Basel I requirements. Yet the most important reforms on increased capital were left to the Basel Committee, whose record is weak. While Basel III has required more capital, there remains the more difficult (if not impossible job) of setting accurate risk weights against which to measure this capital.

One of the great myths of Dodd-Frank is that the new orderly liquidation authority of the FDIC to resolve non-banks will avert future crises. But if important financial institutions are taken over by the FDIC, it is already too late – runs will already be in progress; at best losses can be minimised in resolution. Worse, Dodd-Frank takes away from FDIC its previous power to keep troubled banks alive through open-bank assistance and makes it difficult to preference short-term creditors in any resolution, powers that may be needed to curb runs.

One year on, the act has made future crises more likely while damaging US financial institutions

Dodd-Frank does make some needed corrections in regulation by requiring central clearing of over-the-counter derivatives, more disclosure to investors in securitised loans, more transparency about rating agency methodology and more emphasis on consumer protection. Yet the introduction of these so-called Volcker rules were in truth uncalled for. The crisis had nothing to do with proprietary trading or investment in private funds. Prohibiting these activities deprives US banks of diversification opportunities, and makes them uncompetitive with foreign banks.

This massive revamp of American regulation creates uncertainty for now, and, with Basel III, significant costs in the future, with uncertain benefit. The political debate that produced it was shaped by the popular desire to avoid bail-outs of irresponsible financial institutions. The record shows, however, that these bail-outs worked, and were profitable for taxpayers. Any future shortfalls could be met by taxes on financial institutions or, in the case of deposit insurance, by an increase in premiums. Taxpayers need not be put at risk. In the future bubble-induced crises will, unfortunately, continue. Yet, following the new rules introduced a year ago, containing them will sadly now be more difficult than ever.

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India is too corrupt to become a superpower

Ramachandra Guha

The sociologist Ashis Nandy once noted that "in India the choice could never be between chaos and stability, but between manageable and unmanageable chaos". He wrote this in the 1980s, a decade marked by ethnic and caste violence, and bloody religious riots. It applies even more to the India of today, however, and is being made worse by the deterioration and corruption of India's ruling political elite.

Throughout India's history its chaos has been largely social and political: from its secessionist movements and sectarian pogroms, to enduring territorial conflicts with China and Pakistan. The bomb blasts in Mumbai last week are but the latest example. Yet the Republic of India now faces challenges that are as much moral as social or political.

The Mumbai blasts have only temporarily shifted off the front pages the corruption scandals that more recently dominated. These have revealed the way in which our politicians have abused the state's power of eminent domain, its control of infrastructure contracts and its monopoly of natural resources to enrich themselves. Rectifying this is now India's defining challenge.

These scandals implicate many of the country's most powerful leaders. They include the looting of mineral resources in southern and eastern India; graft in the organising of the Commonwealth Games in New Delhi; the underpricing of mobile phone contracts by billions of dollars; and numerous property scandals in Mumbai. Corruption is not new in India, but the scale and ubiquity of these problems is unprecedented.

Corruption cuts across political parties. It has tainted the media too, with influential editors commonly lobbying pliant politicians to favour particular companies. However, the chief promoters of this malaise have been the politicians themselves.

There is a paradox here; for India is the creation of a generation of visionary and selfless leaders who governed it in the first decades of freedom. They united a disparate nation; gave it a democratic constitution; and respected linguistic and especially religious pluralism, in the conviction that India should not become a Hindu Pakistan. Today's scandals, however, originate in the deterioration of this political class.

Surging growth is another cause. Economic liberalisation has created wealth and jobs, and a class of entrepreneurs unshackled by the state. But its darker side is rising income inequality and sweetheart deals between politicians and businessmen, leading to the loss of billions of dollars to the exchequer.

Was this inevitable? Perhaps not. Since 1991, the word "reform" has been defined in narrowly commercial terms, as the withdrawal of the state from economic activity. The reform of public institutions has been ignored. It is this neglect that has corroded the state's capacity to moderate inequalities, manage social conflict and enforce fair governance.

This could have been anticipated. Over the past three decades, a series of commissions have called for institutional reforms: to insulate administrators and judges from interference by capricious politicians; to prohibit criminals from contesting elections; to curb abuse of the power of eminent domain; to compensate villagers displaced by industrial projects; to improve the now mostly malfunctioning public health system.

Many of these reports have been read by Manmohan Singh, India's scholarly prime minister; several were commissioned by him, which is why the inaction is so disheartening. When Mr Singh became prime minister seven years ago he was seen as incorruptible. Yet, in terms of institutional reform, these have been seven wasted years.

To single out an honest and intelligent man when corruption and criminality flourish may seem unfair. But W.B. Yeats was right: it is when the best lack intensity and conviction that we must fear for our future. Mr Singh has been content to let things ride. He has not stood up to corrupt cabinet colleagues, or promoted greater efficiency in public administration. Whatever the cause – personal diffidence or a political dependence on Sonia Gandhi, his party president – this has greatly damaged his, and India's, credibility.

If nothing else, the corruption scandals will put a temporary halt to premature talk of India's imminent rise to superstardom. Such fancies are characteristic of editors in New Delhi and businessmen in Mumbai, who dream of catching up with and even surpassing China. The truth is that India is in no position to become a superpower. It is not a rising power, nor even an emerging power. It is merely a fascinating, complex and perhaps unique experiment in nationhood and democracy, whose leaders need still to attend to the fault lines within, rather than presume to take on the world without.

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● The Greek government is on the knife-edge of insolvency, yet there is a way eventually to engineer a full repayment of its debts, writes **Jeffrey Sachs**. A deal that seals in low long-term interest rates at levels close to the current German or French borrowing rates, combined with a new bank tax to build an insurance fund against a future default is the best chance to avoid a potential calamity. Greece would then be able service its debts at a manageable rate and have the chance to restore growth. The markets would be spared a disruptive and costly default situation.

● An interest reduction is necessary but no longer sufficient to solve Greece's problems, writes **Sony Kapoor** in response to Jeffrey Sachs. A restructuring that reduces the country's sizeable debt mountain will also be necessary.

American lessons in how to run a single currency

John Kay

In the 1990s, when European monetary union was a plan but not a reality, I would explain to students that the effect was to replace currency risk by credit risk. With exchange rates free to float, loose monetary and fiscal policies would lead sooner or later to a fall in the exchange rate. That expectation implied higher interest rates. Currency markets would limit the scope for bad economic policies.

Monetary union meant sovereign governments could no longer print money. That change put them in the same position as any other borrower: and substantially increased the likelihood of default. Like businesses or households, governments would find that profligacy made loans more and more costly and difficult to obtain. Credit markets would limit the scope for bad economic policies.

This was how decentralised budgeting worked in the US. The federal government does not guarantee the solvency of the states, which can and do go bust – and, as several economic historians have pointed out, have done so without damage to the federal government's credit. Last year, California's issue of 30-year Build America bonds was set to yield 325 basis points above comparable US Treasuries – and no one suggested that this divergence put the US single currency in danger. Within the eurozone, interest rate spreads would be set differently, and might be narrower or wider.

The account I gave these students was profoundly misleading. Interest rates across the eurozone quickly converged. By 2007, European countries with much worse economic situations than California could borrow at rates no more than 20 or 30 basis points higher than Germany. The graph of interest rate spreads across Europe is one of the most widely used in economic presentations. But the significance of that graph is not the vicissitudes since 2007, but the convergence and stability that preceded it.

When New York crassly mismanaged its financial affairs, the president's response was: 'Ford to City: drop dead!'

Why were interest rate spreads in Europe so small? Many participants simply did not care about default possibilities. If there was any interest rate differential at all between eurozone countries, a profitable carry trade was to be long the weaker country and short the stronger one, to finance Greek assets with German liabilities. In a banking book, such a position necessarily yielded regular profits until an actual event of default took place, which would certainly not happen within the next few months. And modern bankers rarely have longer time horizons than a few months.

But markets also doubted whether default would happen. They correctly judged that the European Union's institutions would use financial irresponsibility in one part of the EU, not to reiterate the independence of individual states, but to emphasise the interdependence between them. When New York crassly mismanaged its financial affairs, the president's response was famously paraphrased as "Ford to City: drop dead!" When Greece was guilty of similar mismanagement the reaction of the ECB and the European Commission was "how can we help?".

The crisis in Greece – and Ireland and Portugal and perhaps elsewhere – is a crisis for Europe as a whole. Not because that is the nature of a single currency, but because Europe has consciously chosen to make it one. From its inception, the guiding philosophy of the EU was that if you took every opportunity to promote the mechanisms of integration, political and economic reality would eventually catch up. That was the vision of Robert Schumann and Jean Monnet, and their strategy was successful beyond their dreams.

But such a policy was always risky, because if institutions did not match aspirations then the resulting strains would jeopardise not just future progress but the gains already made. The fate of those who push their luck until it runs out is one of the most familiar stories of business, politics and finance – and is the fate of Europe today. Perhaps we could instead learn some lessons from across the Atlantic. The US has, on the whole successfully, combined an affirmation of states' rights with a powerful federal government, and has maintained a stable currency union since – well, 1865.

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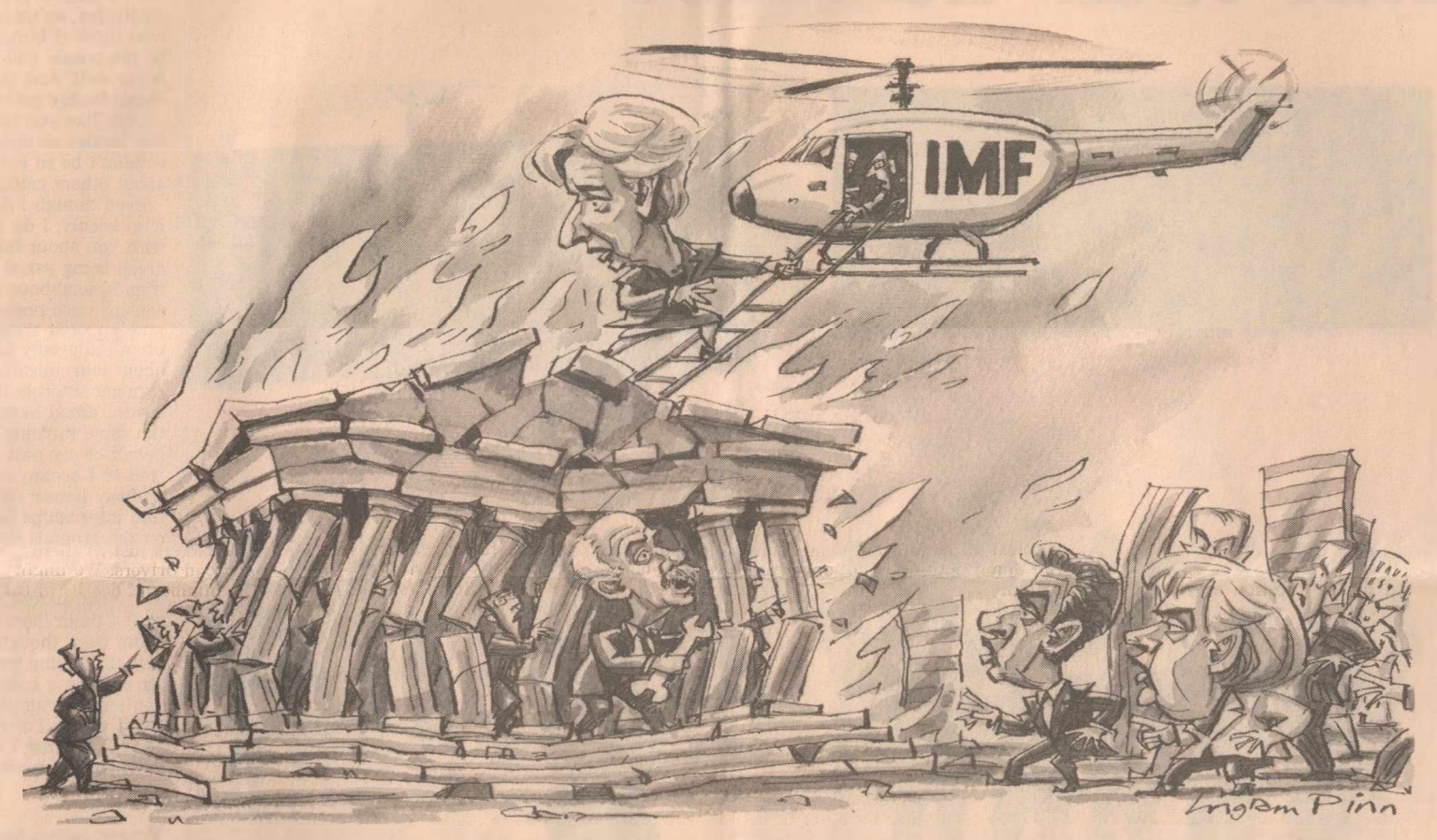
Let Europe pay for its policy failures

Alan Beattie



And so the circus moves on. On Thursday the eurozone authorities, for want of a better term, will be meeting in Brussels for the thousandth iteration of their response to the Greek crisis.

The run-up to the summit, which was supposed to design a second and much larger bail-out for Greece, has been sadly typical of Europe's shambolic and convoluted policy process. The European Central Bank has continued a high-volume but confused row with the eurozone finance ministers about writing down Greek sovereign debt and what does or does not constitute a default.

Watching, with a mixture of resignation and despair, is the institution that parachuted on to the battlefield at the beginning of the bail-out in May 2010, the International Monetary Fund. Anyone who still believes that the IMF is an organisation of sinister omnipotence should take a look at its current situation – and start to think, as some in Washington are, about how the IMF can disengage from a situation where the risk to its reputation is beginning to outweigh the benefit from its presence.

It was a good idea for the IMF to get involved in Greece. That it did reflects the diplomatic skills of its now departed managing director, Dominique Strauss-Kahn. Its participation meant overcoming resistance from truculent Europeans including Jean-Claude Trichet, ECB president, who wanted to sort out the problem themselves.

The IMF brought expertise, credibility and cheap lending. Reasonable people – a category that on this occasion probably even includes most economists – will argue that right from the beginning, Greece was never likely to turn round its public finances without a debt restructuring. But restructuring or no, Greece still needed to turn a primary fiscal deficit into a surplus, and was always likely to find that easier when supported by the IMF.

But partly because of mulish European pride and partly because of the size of the economies involved, the IMF contributed less than a third of the €110bn rescue package announced in May 2010, €30bn to the eurozone's €80bn. This was a new departure: although it had co-financed rescue programmes before, with EU money supplanting its lending in eastern Europe in 2008-09, the fund had in effect operated as the senior partner or had almost complete unity of purpose with the other lenders.

By itself, this junior role may not have mattered too much as long as the fund acted as a credibility gatekeeper, taking a leading role in negotiating and enforcing loan conditionality with the borrower, Greece. But it turns out that what it really needed was to enforce conditionality on its dysfunctional co-lender, the eurozone.

The IMF is a crisis lender, not a benevolent uncle for delinquent rich countries, and it needs to get its money back

All things considered, the Greek government has had a reasonable shot at implementing a very tough combination of heavy fiscal tightening and structural changes.

The real failure is the chaotic babble of eurozone policymaking. It is that discord, as much as a failure of political will in Greece or even the prospect of a debt restructuring per se, that has blown out Greek bond spreads and now infected Italy and Spain with the panic virus.

The IMF now no longer bothers to hide its frustration with European bickering and dithering, and the possibility that the fund will disengage from Greece is increasingly under discussion in Washington. Last week, when it agreed its latest tranche of funding for Greece, the fund made clear that only the wider continental – and possibly global – ramifications of a disorderly Greek default allowed it to continue lending into such an uncertain situation. The main problem was not anything Greece had failed to do, but whether medium-term eurozone funding would be guaranteed, given that private lending, default or no default, is likely to be very slow to return.

Stopping disbursements under the lending programme already agreed would be a nuclear option. But when it comes to augmenting its commitment under a second bail-out, the IMF might be wise to look at the chaos of the European policymaking machinery that underlies it, and say: no thanks. It should refuse point-blank to increase its commitment if that means endorsing any programme such as the voluntary debt rollover plan recently proposed in Paris, which would make the long-term debt problem worse by offering bondholders sweeteners to participate. If the fund declining to add more lending to its current plans causes market disruption, so be it. The IMF is supposed to be there to smooth over liquidity problems, not to pour good money after bad by lending to insolvent governments. If the eurozone wants to follow a boneheaded rescue strategy, let it pay for it.

In an important and disturbing sense, the IMF's insistence on substantial long-term eurozone financing may become a form of self-preservation. At some point, it is inevitable that the countries underwriting the eurozone rescue effort, notably Germany, will have to write off some of their own losses or in some other way effect a fiscal transfer to Greece. The IMF will not: it is a crisis lender, not a benevolent uncle for delinquent rich countries, and it needs to be clear that there will be enough eurozone cash coming in that it can get its money back.

The IMF needs to think hard about the company it chooses. Mr Strauss-Kahn rightly took a calculated risk and got the fund into the thick of the capital markets firefight in Greece. Christine Lagarde, his successor, might well be the one to organise it being airlifted out.

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Murdoch and a Tiger-mother masterclass

Philip Delves Broughton

It was even more of a family affair than anyone anticipated. Rupert and James Murdoch were on the schedule for Tuesday's House of Commons Culture, Media and Sport Committee. Not so, Wendi Murdoch's right fist. After sitting demurely and her husband for two hours, Rupert's Chinese-born wife gave new meaning to the phrase Tiger mother, by pummelling the intruder who had burst into the room to lather her husband with a foam pie.

For connoisseurs of management, and moguls in particular, though, the proceedings offered a master class in crisis management. James Murdoch was good, if a little reedy, wordy and over-drilled by his lawyers. He did all the necessary blocking and tackling to get through a tricky afternoon. His father, though, was magnificent, initially as terse as an outback farmer, but slowly unveiling the lethal charm even his rivals describe as mesmeric. He may have been spinning, but it didn't sound that way. He made clear that he understood the gravity of the situation and the need to rectify it. But at times he showed all the interest of Caesar being grilled about some long-forgotten incident in the Londinium aqueduct authority. He responded to the MPs' rambling questions with theatrical pauses, often followed by a simple "yes" or "no". But when he needed to make a point, he banged the table, rattling his microphone, as if berating an insubordinate prime minister.

By taking over management of the scandal, Mr Murdoch is finally heeding the lessons of the most widely taught crisis management case in business: Johnson & Johnson's response after seven people died from cyanide-laced Tylenol capsules in 1982. While police sought the psychopath responsible, the company pulled all 31 million bottles of Tylenol from shelves across the United States, at a cost of $100 million. James Burke, its CEO, appeared endlessly to apologise and reassure the public. Tylenol sales quickly rebounded.

Until yesterday, Mr Murdoch had left it to Rebekah Brooks, the former chief executive of News International, and his son James, to be the faces of the scandal. Given the sheer scale of News Corp, it doubtless seemed a local difficulty, pumped up by a hysterical British press. The revelation that News of the World reporters had hacked the phone of the murdered schoolgirl Milly Dowler turned the scandal toxic and demanded his intervention.

At times the Murdochs addressed the MPs in the House of Commons committee as if they were a dim MBA class

The MPs did their best to challenge him, but they were up against a man who has built his company over 57 years, who employs 52,000 people around the world, who broke the British print unions, barged into US network television, and gave us *Titanic* and *Avatar*. Pressed on details of the hacking scandal, he said that the News of the World represented a tiny fraction of News Corp, less than 1 per cent of its $33bn revenues last year. At times the Murdochs addressed the MPs as if they were a slightly dim MBA class. In large businesses, they explained, it was customary to delegate authority to managers, and that these managers had a certain amount of discretion to make decisions and manage budgets. Such systems rely on measures of trust.

Defending his son's handling of the scandal, Mr Murdoch said that in any given week James had to spend "a day in Munich, a day at Sky Italia where he had a particularly difficult situation, and a particularly tricky competitor, if I might say so", a sly dig at Silvio Berlusconi. While the MPs pettifogged, he implied, the Murdochs ran the world.

Entering hour two, Murdoch Snr softened. He sympathised with the MPs for their dismal pay, and suggested a Singaporean model, where legislators are paid so well they have no need to fiddle their expenses. Intimidate first, then charm, advise the management texts on crisis and change management. Murdoch did just that.

By the end of the session, Mr Murdoch seemed avuncular, a chief executive in full, deeply sorry for the worst of the phone hacking, feeling betrayed by his managers and promising to make it right. He talked of his pride in his father, a journalist and small newspaper owner who had exposed the scandal of Gallipoli, and his belief in the role of newspapers in ensuring transparency in public life. The politicians, you sensed, were in his palm, awed by the plain fact of his being there, and embarrassed by the pie-thrower.

When asked at the end of the hearing why he hadn't resigned, he answered: "Frankly, I'm the best person to clear this up." It comes late, but given all that he has seen and done in his life, it is hard to disagree with him.

The writer is author of What They Teach You at Harvard Business School: My Two Years in the Cauldron of Capitalism