FINANCIAL TIMES

87a

October 23, 2011 5:21 pm

Europe is now leveraging for a catastrophe

By Wolfgang Münchau

It is time to prepare for the unthinkable: there is now a significant probability the euro will not survive in its current form. This is not because I am predicting the failure by European leaders to agree a deal. In fact, I believe they will. My concern is not about failure to agree, but the consequences of an agreement. I am writing this column before the results of Sunday's European summit were known. It appeared that a final agreement would not be reached until Wednesday. Under consideration has been a leveraged European financial stability facility, perhaps accompanied by new instruments from the International Monetary Fund.

A leveraged EFSF is attractive to politicians for the same reason that subprime mortgages once appeared attractive to borrowers. Leverage can have different economic functions, but in these cases it simply disguises a lack of money. The idea is to turn the EFSF into a monoline insurer for sovereign bonds. It is worth recalling that the role of those monolines during the bubble was to insure toxic credit products. They ended up as a crisis amplifier.

Technically, the EFSF monoline insurer would provide a first-loss tranche insurance for government bonds up to an agreed percentage. It sounds like a neat idea, until the recipients of the insurance realise their sovereign bonds have turned into hard-to-value structured products. One of the factors that will make them hard to value is the incalculable probability that France might lose its triple A rating. In that case, the EFSF would automatically lose its own triple A rating – which is derived from that of its guarantors. The EFSF's yields would then rise, and the value of the insurance would be greatly reduced. The construction could ultimately collapse.

Leveraging also massively increases the probability of a loss for the triple A-rated member states, who ultimately provide the insurance. If a recipient of the guarantee were to impose a relatively small haircut – say 20 per cent – the EFSF and its guarantors would take the entire hit. Under current arrangements, they would only lose their share of the haircut.

The simple reason why there can be no technical quick fix is that the crisis is, at its heart, political. The triple A-rated countries have left no doubt that they are willing to support the system, but only up to a certain point. And we are well beyond that point now. If Germany continued to reject an increase in its own liabilities, debt monetisation through the European Central Bank and eurobonds, the crisis would logically end in a break-up. There is no way the member states of the eurozone's periphery can sustainably service their private and public debts, and adjust their economies at the same time.

Each of Germany's red lines has some justification on its own. But together they are toxic for the eurozone. The politics is not getting any easier. The behaviour of the Bundestagunderlines the political nature of the crisis. Last month's ruling of Germany's constitutional court strengthened the role of parliament. But it also reduced the autonomy of the German chancellor, who now has to seek prior approval by the Bundestag's budget committee before negotiating in Brussels. This power shift will not prevent agreements, such as the one currently negotiated, but it will make it harder to co-ordinate policy in the European Council on an ongoing basis.

The way eurozone leaders have been handling the crisis ultimately vindicates the German constitutional court's conservatism in its definition of what constitutes a functioning democracy. Policy co-ordination among heads of state is both undemocratic and ineffective. A monetary union may require more than just a eurobond and a small fiscal union. It may require a formal, if partial, transfer of sovereignty to the centre – that includes the rights to levy certain taxes, impose regulation in product, labour and financial markets, and to set fiscal rules for member states.

Under normal circumstances, European electorates would not accept such a massive transfer of sovereignty. I would not completely exclude the possibility that they might accept it if the alternative was a breakdown of the euro. Even then, I would not bet on such an outcome. Current policy is leading us straight towards this bifurcation point, which may only be a few weeks or months away.

The biggest danger now is the large number of politicians drawing red lines in the sand, and the lack of even a single EU authority willing and capable of cutting through them. Given the multiple uncertainties, there is no way to attach any precise probabilities to any scenarios. But clearly, the chance of a catastrophic accident is bigger than merely non-trivial. The main consequences of leverage will be to increase that probability.

munchau@eurointelligence.com

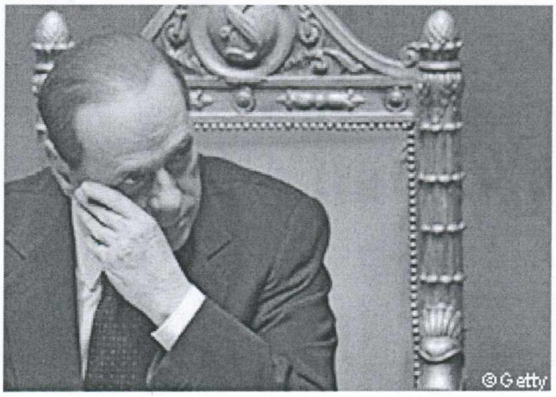
More columns at www.ft.com/wolfgangmunchau

FINANCIAL TIMES

October 23, 2011 7:15 pm

Pressure on Italy in eurozone struggle

By Quentin Peel, Peter Spiegel and Hugh Carnegy in Brussels



Italian Prime Minister Silvio Berlusconi reacts after addressing the Senate

Germany and France have turned on Italy to demand further action to boost growth and reduce its huge debt, as leaders of the eurozone struggled to agree on how to boost their rescue fund to stop contagion in the sovereign debt markets before a Wednesday deadline.

Angela Merkel, the German chancellor, and Nicolas Sarkozy, French president, held tough talks with Silvio Berlusconi, at the start of the day-long summit in Brussels, insisting that he take more radical measures to restore the trust of investors.

Confidence in Italy's public finances is critical to preventing the spread of the Greek debt crisis across the eurozone, but France and Germany are worried that Mr Berlusconi is not taking tough enough measures.

"Italy is a big and important partner," said Ms Merkel, saying further structural reforms were essential. "Everything must be done for it to live up to its responsibilities."

The clash with Mr Berlusconi came as 27 European Union leaders negotiated the three pillars of a package aimed at stemming the crisis. They agreed on the need for European banks to find €108bn in new capital to persuade investors that they can withstand the pressures of the sovereign debt crisis.

On Sunday night, the 17 eurozone leaders debated without reaching a conclusion two potential models to expand the financial firepower of their €440bn European financial stability facility – the eurozone rescue fund – using financial engineering to leverage the core capital by up to five times.

One plan would set up a special fund to attract global investors, including potentially the IMF, that would buy Italian bonds and those of other troubled eurozone countries. The other, which could run in parallel, would guarantee against losses by bondholders. Ms Merkel and Mr Sarkozy warned that both plans involved technical complexity.

At the same time top-level officials were negotiating with a consortium of international banks to increase their contribution to a new rescue plan for Greece, to cut the country's debt burden. Without further cuts in repayments to bondholders, EU and IMF lenders will be saddled with

€252bn in bail-out loans until the end of 2020, according to a confidential EU-IMF study. Negotiators said the two sides remained far apart on the size of any debt writedown.

The three elements of the package are supposed to be decided by twin EU and eurozone summits on Wednesday. Non-members of the eurozone, led by Britain, Poland and Sweden, insisted they come back to Brussels to sign off on the bank recapitalisation plan before the final eurozone summit.

Mr Sarkozy said there were "more long hours of discussion to come" before a final accord could be reached but expressed his absolute determination – with Ms Merkel – to produce "solid and durable" common proposals by Wednesday.

Yet Ms Merkel's and Mr Sarkozy's joint frustration with Mr Berlusconi was made dramatically clear at a joint press conference. Asked if the Italian prime minister had reassured them about his action to reduce his country's debt level, they looked at each other with wry smiles, casting their eyes to the ceiling.

"We are conscious of the responsibility of all the authorities in Italy," said Mr Sarkozy. Asked if she trusted Mr Berlusconi, Ms Merkel replied: "He is our interlocutor, and naturally we are relying on him."

FINANCIAL TIMES

878

Last updated: October 23, 2011 7:34 pm

Banks must find €108bn in new capital

By Alex Barker in Brussels

© AFP/Getty Images

Europe's big banks will be forced to find €108bn of fresh capital over the next six to nine months under a deal to strengthen the banking system that is to be unveiled by European Union leaders.

After 10 hours of talks in Brussels on Saturday, finance ministers from all 27 EU member states endorsed an estimate of the sector's capital shortfall that is significantly higher than initial calculations. But strong reservations from southern European countries, who will have to find the lion's share of the money, have delayed a full announcement until Wednesday, when the necessary state guarantees are set to be agreed.

According to two people involved with the talks, the European Banking Authority told finance ministers that its final emergency stress test had identified a total of €108bn ($150bn) to be raised by Europe's banks. This would allow lenders to meet a 9 per cent threshold for their core tier one capital ratios – a measure of financial strength that goes beyond existing requirements – after marking down to market values their sovereign bond holdings of the eurozone's peripheral states.

The recapitalisation plan will also include measures to co-ordinate national efforts to unblock bank funding through state guarantees for new bank bonds. But Germany successfully opposed the use of joint rescue funds to underwrite new bonds, a step analysts say is essential to improving liquidity for banks, particularly on the southern periphery.

While the size of the capital shortfall is broadly agreed, big differences remain over increasing the firepower of the European financial stability facility, the eurozone's €440bn rescue fund, which some states would borrow from for the recapitalisation.

Diplomats said the deal proved far harder than expected because Italy, Portugal and Spain resisted signing up to raising the capital bar without more certainty about state assistance for any banks unable to raise the capital themselves. Germany, however, showed little sympathy, insisting national resources were sufficient in most cases. "It was a dialogue of the deaf," said one diplomat.

Banks will be told to use their own resources or raise new funds from private investors, government or, as a last resort, turning to the EFSF rescue fund.

As well as banks in bail-out countries – which account for almost half the shortfall – institutions in Germany, France, Italy and Spain will be required to find new capital. No UK banks fall under the threshold.

The deal is a victory for those countries that resisted calls for the tests to be watered down, either through reducing capital demands or changing the method for writing down sovereign debt.

Although the basic assumptions in the test are largely unchanged, fresh data from national supervisors around Europe pushed up the estimate of the shortfall from the €80bn figure calculated by the EBA last week. Even so, the final figure falls well short of some market estimates of the necessary amount. A recent International Monetary Fund report identified a €200bn hole in banks' balance sheets stemming from sovereign debt writedowns, while other analysts have put the deficit as high as €275bn.