European Union summit

A weekend to save the euro

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As leaders once again gather in search of a solution to the debt crisis, the task they face appears ever more complex. *By Peter Spiegel and Alex Barker*

In the nearly two years European leaders have spent trying to tackle the eurozone debt crisis, the summits foreshadowed as those that will finally pull off the grand bargain that puts the single currency back on a firm footing are almost too numerous to count.

What sets Sunday's summit in Brussels apart is that policymakers' greatest fear at the start of the crisis – that the fiscal troubles of a small country on Europe's periphery would infect the global economy – has come true.

Greek debts, even at €350bn ($483bn), could be absorbed easily by a continent as prosperous as Europe. Even if the European Union were forced to take over all Athens' debts, the cost would be a fraction of that incurred by west Germany's difficult absorption of the weaker east.

What has always made Greece dangerous is the precedent it set. For investors and critical analysts, ever changing policies towards the country have raised questions about whether European leaders can be trusted to protect and rescue less troubled economies. Once lost, that confidence has proved almost impossible to regain.

The shifts have been gradual but cumulatively drastic. At first, in May 2010, Athens' debts would be met in full by a €110bn bail-out and "default" was a *verboten* word. Five months on, Germany convinced France to allow defaults, but only from 2013.

By May 2011, immediate Greek defaults were on the table, but only small ones. Now, 50 per cent defaults on sovereign debt are being pushed by some of Greece's largest EU creditors.

The shifts at first led to investor runs on other peripheral countries – Ireland then Portugal – whose debts were not as big as those of Greece but big enough to raise concerns that European policymakers would treat them as they were treating Athens. Then, starting in July, Italy and Spain became infected. Once sovereign bonds of core eurozone countries began taking hits, it undermined almost every big European bank, all of which hold vast portfolios of government debt.

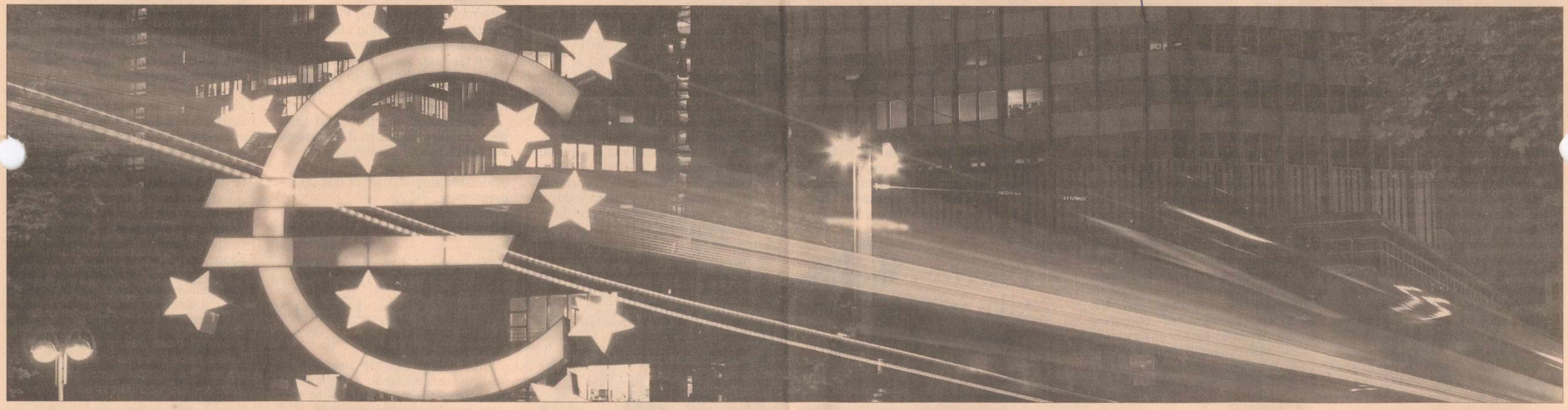
Italy can still borrow in public markets, but only at rates many think unsustainable. Europe's most troubled banks (notably Dexia, the Franco-Belgian lender) have begun to fail and bigger, systemically important ones are at risk. The next domino may be close to falling: if systemic European banks freeze up, Asian and US lenders that are intertwined with Europe's financial system could be infected, throwing the world back towards a Lehman Brothers-style meltdown. "The European problem has become internationalised," says Mujtaba Rahman, an analyst at Eurasia Group. "To the extent global economic prosperity now rests on the shoulders of Europeans, it raises the stakes to where we haven't seen before."

To meet the challenge, Europe's leaders are trying to solve three simultaneous problems by Sunday night: putting Greece on a solid foundation through a second bail-out; re-establishing confidence in Europe's largest banks by ordering them to raise capital; and giving the newly empowered €440bn eurozone rescue fund more firepower so it can ensure Greek difficulties do not spread to Italy and larger financial institutions.

But as the summit gets closer, senior European officials are warning that the complexity of the three interlinked problems are so enormous, the differences between Paris and Berlin so large, and the time so short that a credible deal may prove out of reach.

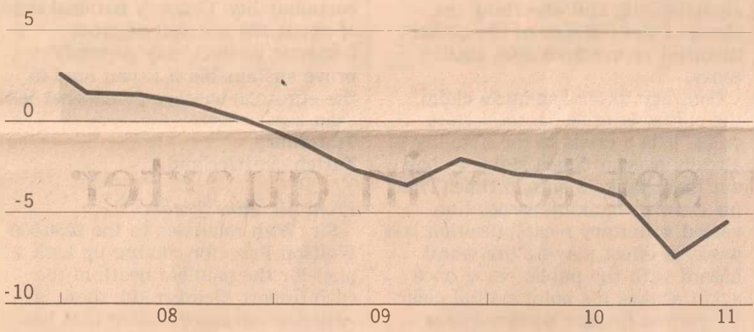
One senior European official, noting that Berlin has begun playing down expectations, says: "They'd rather talk it down now than explain why there's a disaster on Sunday."

Additional reporting by Ralph Atkins, Hugh Carnegy, Kerin Hope and Richard Milne



Problem 1
Greece's second bail-out
The question is how harsh a haircut

Athens' agonies
Greek real GDP (annual % change)



Source: Thomson Reuters Datastream

The first €110bn bail-out was never big enough to meet Athens' financing needs through to mid-2013 as intended. It envisioned Greece returning to the bond market by early next year, an assumption that quickly became unrealistic as he crisis grew.

The easy answer would have been to lend more money, but a German-led group of creditor countries was beset by political backlashes against bail-outs. So the Rubicon was crossed: for the first time, bondholders would see their payouts cut through "haircuts" so that taxpayers would not meet the entire bill. But to make the deal palatable to the European Central Bank, which feared haircuts would spark investor panic, bondholders would have to take losses "voluntarily".

Under a deal reached in July, holders of Greek debt would swap their bonds for new, triple A rated ones. The good news for investors was that the new ones would have the same face value as the old; the bad news was that, rather than being repaid now, they would not be repaid for 30 years. Banks estimated that the delay meant their holdings would be worth 21 per cent less.

Three months later, Greece's economic situation has deteriorated significantly, meaning July's bail-out deal needs to be reworked. In addition, the value of the old Greek bonds to be traded in has fallen, and the new ones are worth more. So the German-led group of countries is pushing to reopen the July deal and impose deeper haircuts.

● Potential solutions
Three solutions have been debated in eurozone policy circles. The first is a bond buy-back, where eurozone rescue funds would be used to buy old Greek bonds at current, depressed levels – some are trading at 40 per cent of face value. This French-backed repurchase programme would be both voluntary and a haircut.

The second proposal, pushed by some in Germany, is a full-scale default. Bondholders would simply be informed they would be repaid only 50 per cent of what they are due, and Greek debt levels would be cut in half. This is likely to maximise investor panic, however, and is resisted by the ECB and France.

The most likely solution is a tweak of the July swap plan. By adjusting interest rates paid on the new bonds, the length of the repayment schedule, and the collateral used to back the bonds, the original 21 per cent reduction can be turned into 50 per cent relatively easily.

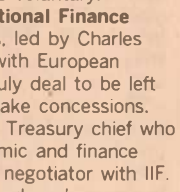
● Fizzle factor
European banks said confirmation the July deal was to be reopened came only last Tuesday; and as the largest institutional holders of Greek debt, they are resistant. People on both sides of the negotiations believe they will give in – though whether other bondholders will do so is doubtful.

Also in doubt is whether France and Germany can agree on a haircut level. Berlin wants 50-60 per cent; Paris, closer to 30 per cent. French banks, with their vast holdings of sovereign debt, are more vulnerable than most to the panic a big haircut could bring.

One senior aide to a eurozone prime minister doubts all the details will be ready by Sunday. "On some issues, we are going to just have to set up some kind of framework and have the details agreed later," the aide says.

● Players
France Wanted a buy-back programme but now pushing for more limited haircuts by adjusting the July deal. Insisting on all haircuts being voluntary.
Germany Some officials were pushing for a hard default but Berlin has come round to the idea of adjusting the July deal. Still wants big haircuts.
ECB Has always opposed haircuts but gave in to Berlin in July – though it insists that Greece must remain a one-off and any default is voluntary.
Institute of International Finance Consortium of banks, led by Charles Dallara, negotiating with European officials. Called for July deal to be left alone but likely to make concessions.
Vittorio Grilli Italian Treasury chief who heads the EU economic and finance committee; chief EU negotiator with IIF.
Greece George Papandreou's government is siding with France for limited haircuts of 30-35 per cent since domestic banks are the largest holders of Greek sovereign debt.

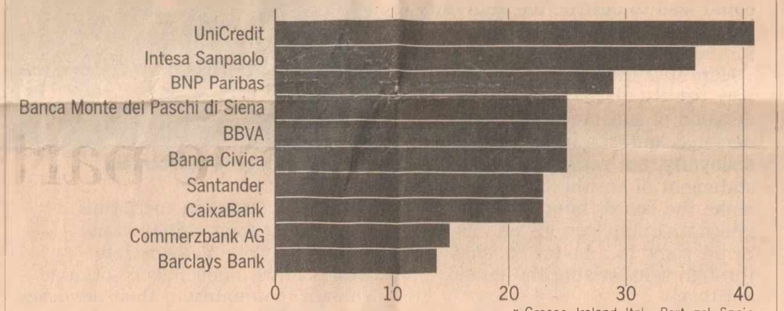

Grilli: concessions sought from banks


Dallara: wants July pact kept


Papandreou: fears for Greek outlook

Problem 2
Recapitalising Europe's banks
But where to find the money?

Lenders on the line
Banks most exposed to peripheral* eurozone debt
First half of 2011 ($bn)



* Greece, Ireland, Italy, Portugal, Spain

Source: Morgan Stanley

As the crisis has intensified, some European banks have struggled to borrow money to run day-to-day operations. The usual lenders, such as US money market funds, are increasingly circumspect, believing that banks' financial health as measured by capital ratios has been undermined by the falling value of their sovereign bond holdings.

For much of the crisis, the ECB has been the source of emergency lending – but the big levels of liquidity required rattled markets this summer, leading shares of French and other banks to plummet.

After months of blaming speculators and denying that there was a problem, finance ministers have accepted that capital buffers need to be strengthened to restore market confidence. The trouble is that regulators, governments and EU officials disagree on the size of the problem and how to fix it. Even if a master plan is agreed, some states may lack the credit to pay for it.

● Potential solutions
Any deal will require agreement on three points. Officials must decide how to value the sovereign debt on each bank's books; and how much additional capital the new valuation requires. Finally, they must find money for banks that cannot raise capital themselves.

The European Banking Authority, the EU banking regulator led by Andrea Enria, is deciding on the size of the capital hole. It is updating data from lenders and marking down sovereign bonds in line with current market prices. Using this new data, it is likely to set a temporary bar forcing banks to hold 9 per cent core tier one capital – a key measure of financial strength.

The assumptions used in the debt analysis and setting the capital bar are crucial; depending on the model, estimates of the capital shortfall range from below €100bn to €300bn. Political tension is rising over how much time banks will be given to reach the bar and what forms of capital will count.

The question of who picks up the tab for banks that cannot raise their own capital is proving equally sticky. France has backed down from insisting that the European financial stability facility, the eurozone's €440bn rescue fund, should be a first line of defence, though there are signs it is looking for ways to avoid any government rescue adding to its own debt levels – particularly after credit rating agency Moody's issued a warning on its triple A status.

● Fizzle factor
The consensus market view is that European banks need recapitalisations of about €200bn. But the plan that emerges from the summit is likely to fall short; the latest EBA analysis puts the shortfall at €80bn-€100bn.

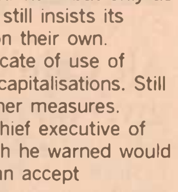
Some countries are pushing for smaller banks to be exempted; others for a lower core tier one capital bar. The EBA, meanwhile, is basing its analysis on today's distressed debt prices and not on an economic downturn, as it did in stress tests whose results were issued in July.

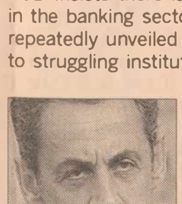
Then there is the matter of timing. Some officials are pushing for the recapitalisation to be completed within six months to convince markets of their seriousness but the deadline could be extended until French presidential elections in April.

Banks are resisting the exercise, insisting capital levels are adequate. They warn the proposals could have an unintended consequence; they would try to shrink their way out of trouble, selling assets or cutting lending instead of raising new equity. This would starve consumers and businesses of cash, deepening the eurozone's woes.

● Players
EBA Pushing for tough requirements after July stress tests deemed inadequate. Backed by Brussels.
France President Nicolas Sarkozy is reluctantly on board for using national funds for recapitalisations – but only as a last resort. France still insists its banks can manage on their own.
Germany Early advocate of use of national funds for recapitalisations. Still resisting EBA's tougher measures.
Josef Ackermann Chief executive of Deutsche Bank, which he warned would sell assets rather than accept government funds.
ECB Insists there is adequate liquidity in the banking sector, even as it has repeatedly unveiled new facilities to lend to struggling institutions.


Sarkozy: willing as last resort


Ackermann: ready to sell assets


Enria: EBA wants tough standards

Problem 3
Raising the firewalls
How to make a fixed fund go further

Contagion concerns
10-year bond yields for troubled non-bail-out eurozone countries (%)

Source: Thomson Reuters Datastream

Once Greek defaults had been allowed, officials acknowledged that existing ways of preventing panic from spreading were inadequate. National efforts to shore up banks were being resisted by voters and bankers, and the ECB faced pressure from German chancellor Angela Merkel to end its efforts to prevent runs on Spanish and Italian debt by buying sovereign bonds itself.

This month, the EFSF received new powers to inject capital into banks and purchase bonds, when Slovakia became the final country to approve the measures. But while €440bn may have been enough to rescue small countries such as Greece, officials agree it is not enough to deal with the largest banks and economies.

● Possible solutions
Because of the bail-out backlash and the risk to France's triple A rating, EU leaders cannot increase the fund's size. Instead, they are seeking to "leverage" its assets to give it more firepower. France and European Commission officials favoured linking the EFSF to the unlimited funding at the ECB, which can literally print money. Proposals included turning the fund into a bank and giving it access to the ECB's low-cost borrowing programmes; or allowing the ECB to continue bond purchases, with losses covered by the EFSF. Berlin and the ECB have blocked the plans. "The ECB-related options are off the table and we are looking for the best of the second-best alternatives," says a senior European official.

Although four or five options are still being discussed – including convincing private banks to step into the ECB's lending role or letting the EFSF loan collateral to struggling states to make their bonds more credible – the likely option is for the EFSF to guarantee losses on Italian and Spanish bonds.

Another senior European official says discussions began with the EFSF covering 10 per cent of losses, which has moved to 20 per cent; some are urging 30 per cent. By guaranteeing losses instead of purchasing bonds, the EFSF can have a bigger impact without spending any cash.

● Fizzle factor
Although the EFSF has €440bn in funding, the amount it can now use is much lower. Not only have the Greek, Irish and Portuguese bail-outs used up EFSF resources, but they have also withdrawn their commitments to the fund, leaving only about €250bn to play with. Furthermore, €230bn in EFSF guarantees comes from Spain and Italy, meaning troubled countries would be lending to themselves.

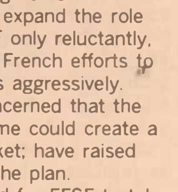
Assuming officials can use €250bn in assets, a 20 per cent guarantee brings the total leveraged value to just a little more than €1,000bn – below the €2,000bn-€3,000bn some analysts believe is needed. German officials are having trouble selling even the reduced figure to parliamentarians.

The realisation the EFSF could yet fall short was one reason some officials explored asking the International Monetary Fund to set up its own facilities to help Spain and Italy, using cash lent by willing developing countries such as Brazil and China. But at last week's meeting of finance ministers from the Group of 20 leading nations, IMF plans were blocked by the US and UK, which face political pressure to avoid entanglement in the eurozone.

Still, Beat Siegenthaler of UBS says the EFSF deal will be used by officials trying to impress markets, papering over "an underwhelming compromise" on bank recapitalisations and an "unconvincing" agreement on Greece.

● Players
France Most concerned about creating a "wall of money" to fight contagion. Aggressively pushing for the EFSF to be leveraged as much as possible.
European Commission Has warned under José Manuel Barroso of the need to increase the size and scope of the EFSF for nearly a year; only now are national capitals in agreement.
Germany Agreed to expand the role and size of the EFSF only reluctantly, and is now resisting French efforts to leverage EFSF assets aggressively.
Spain and Italy Concerned that the loss guarantee scheme could create a "two-tier" bond market; have raised some objections to the plan.
ECB Has long argued for EFSF to take over bond-buying and be given other powers but, under outgoing president Jean-Claude Trichet, blocked proposals for ECB to be included in leveraging.


Merkel: resisting French efforts


Barroso: need for stronger EFSF


Trichet: blocked leverage proposals

Europe needs the ECB to step up to the plate

Paul De Grauwe

The sovereign debt crisis has degenerated into a banking crisis. One did not need an economics degree to predict this. A sovereign debt crisis always leads to a banking crisis. Yet policymakers did not see it coming, or if they did, they failed to act in time.

We now hear that the solution is a massive and quick recapitalisation of banks. Such a recapitalisation is seen by many as an essential ingredient in the grand rescue package that the European leaders will be discussing this weekend. But who can recapitalise the eurozone banks quickly? Given volatile conditions in equity markets, only governments can swiftly garner the financial resources necessary. But to do so, governments would have to issue more debt. The results are very predictable. Rating agencies would blindly downgrade governments that participated and this would inevitably intensify the debt crisis.

Recapitalising banks made sense during the banking crisis of 2008 when governments had debt burdens significantly lower than they are today. This time round governments cannot recapitalise banks without triggering downgrades and renewed fears of sovereign default. This leads to a vicious circle: recapitalisations undermine the creditworthiness of governments and this then feeds back in to the banks, which see the value of their assets (government bonds) decline further. The more governments recapitalise, the more the value of the banks' assets falls, leading to the need for further recapitalisations.

To stop the downward spiral a floor has to be put on the price of government bonds in the eurozone and the European Central Bank is the only institution capable of implementing it. To prevent further drops in government bond prices, the bank should announce that it is ready to intervene in the market. The ECB is the only institution capable of doing this because it can create money without limit. In announcing its unconditional commitment, the bank would stop the spiral of decline. And when investors were convinced of the resolve of the ECB, they would stop selling sovereign bonds because they would trust that a floor had been put on their prices. The beauty of this outcome would be that the ECB would not have to buy government bonds any more.

Today the ECB does not reap this benefit because it has made it clear that it thoroughly dislikes being a lender of last resort and that it would like to stop as soon as possible. Why would bondholders, who are uncertain about the future value of their bonds, stop selling these when the ECB continues to signal that it does not trust these bonds either?

In theory the central bank should only buy the bonds of illiquid but solvent governments. It is easy to see that this rule excludes Greece. It does not exclude the bond markets of other countries where fear has driven the interest rates to such high levels that, if maintained, it would make any government insolvent. It is in these markets that the ECB has to intervene with a clear commitment.

Many objections are raised against the idea that the ECB should act as a lender of last resort in government bond markets. One is that it amounts to monetary financing of budget deficits, which in turn leads to inflation. This is unfounded. When the ECB buys government bonds in the secondary markets it provides liquidity, not to governments but to the financial institutions that sold the sovereign bonds. When these financial institutions sell government bonds they are in search of a safe asset, and this is primarily central bank money. That money is hoarded and is not used to expand credit and the money supply, and so does not lead to inflationary pressures.

The only reasonable objection to a lender of last resort role for the ECB is moral hazard. By announcing its readiness to provide liquidity in the government bond markets, the ECB creates the risk that governments may reduce their efforts at cutting deficits and debts. That is why binding rules that would force governments to bring their budgetary house in order must complement the ECB's role of lender of last resort. These rules are now being put into place.

The European financial stability facility is no substitute for the ECB. The fund will not be capable of acting quickly even if its resources are expanded by giving it access to the ECB's liquidity. The reason is that its governance is based on unanimity rule and will paralyse it when quick action is required.

The ECB has no excuse not to act. In trying to keep its monetary virginity intact, the bank threatens to destroy the eurozone. If that happens, nobody will be able to profit from its virginity.

The writer is professor of economics at the University of Leuven