As crisis deepens, E.C.B. stands firm

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FRANKFURT

Bank insists weak states mend their ways before fully opening its spigots

BY JACK EWING

To some people, the European Central Bank seems like a fire department that is letting the house burn down to teach the children not to play with matches.

The E.C.B. has a fire hose — its ability to print money. But the bank is refusing

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to train it on the euro zone's debt crisis.

The flames climbed higher Friday after the Italian Treasury had to pay an interest rate of 6.5 percent on a new issue of six-month bills. That was more than three percentage points above what Italy paid to sell similar debt on Oct. 26. It was the highest interest rate Italy has had to pay to sell such debt since August 1997, according to Bloomberg News.

But there is no sign the E.C.B. plans a major response, like buying large quantities of the country's bonds to bring down its borrowing costs. The E.C.B. "is not the fiscal lender of last resort to sovereigns," José Manuel González-Páramo, a member of the executive board of the bank, told an audience at Oxford University late Thursday, a view that has been repeated often by members of the bank's governing council in recent weeks.

To many commentators the E.C.B.'s attitude seems so incomprehensible that they assume the central bank is just putting pressure on politicians to make sure they keep their promises. Rather than let the euro break apart, the thinking goes, the bank will eventually relent and drench the economy with cash as the U.S. Federal Reserve and Bank of England have done.

But another possibility is that when the E.C.B. says "no," it in fact means "no."

"I think markets are going up a blind alley thinking there's is going to be a common euro bond or thinking that the E.C.B. is going to act as a lender of last resort," Norman Lamont, the former British finance minister, told Bloomberg on Friday. "I think Germany would rather leave the euro than see the E.C.B.'s integrity affected."

Instead, the E.C.B. insists, euro area governments must amend their errant ways. "Governments need to ensure, un-

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JOHN GUILLEMIN/BLOOMBERG

HUNGARY'S CREDIT DOWNGRADED TO JUNK
Moody's hinted at further cuts because of doubts about the government of Viktor Orban, above. *PAGE 8*

Banks search for Plan B should euro zone collapse

PARIS

BY LIZ ALDERMAN

For the growing chorus of observers who fear that a breakup of the euro zone might be at hand, Chancellor Angela Merkel of Germany has a pointed rebuke: it is never going to happen.

But a number of banks are no longer so sure, especially as the sovereign debt crisis threatened to ensnare Germany itself this past week when a bond issue faltered, leading investors to question the country's stature as the pillar of euro zone stability.

While European leaders still insist there is no need to draw up a Plan B, some of the world's biggest banks, and their supervisors, are doing just that.

"We cannot be, and are not, complacent on this front," Andrew Bailey, a director at the British Financial Services Authority, said this past week. "We must not ignore the prospect of a disorderly departure of some countries from the euro zone."

Banks including Merrill Lynch, Barclays Capital and Nomura issued a cascade of reports this past week examining the likelihood of a breakup of the euro zone.

"The euro zone financial crisis has entered a far more dangerous phase," analysts at Nomura wrote Friday. Unless the European Central Bank steps in to help where politicians have failed, "a euro breakup now appears probable rather than possible," the bank said.

Major British financial institutions, like Royal Bank of Scotland, are drawing up contingency plans in case the unthinkable veers toward reality, bank supervisors said Thursday. U.S. regulators have been pushing American banks like Citigroup and others to reduce their exposure to the euro zone.

In Asia, the authorities in Hong Kong have stepped up their monitoring of the international exposure of foreign and local banks in light of the European crisis.

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Banks search for a Plan B should euro collapse

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By contrast, banks in core euro zone countries, which have only recently been affected by the crisis, do not seem to be nearly as flustered.

Banks in France and Italy in particular are not creating backup plans, bankers say, because they have concluded it is impossible for the euro to break up. Although banks like BNP Paribas, Société Générale, UniCredit and others recently dumped tens of billions of euros' worth of European sovereign debt, the thinking is that there is little reason to do more.

"While in the United States there is clearly a view that Europe can break up, here we believe Europe must remain as it is," said one French banker, who was not authorized to speak publicly. "So no one is saying, We need a fallback."

When Intesa Sanpaolo, a large Italian bank, evaluated different outlooks in preparation for its 2011-13 strategic plan last March, none were based on the possible breakup of the euro, said Andrea Beltratti, chairman the bank's management board. "Even though the situation has evolved, we haven't revised our scenario to take that into consideration," he said.

European leaders said this past week that they were more determined than ever to keep the single-currency alive — especially with elections looming in France next year and Germany in 2013. If anything, Mrs. Merkel said she would redouble her efforts to push the union toward greater fiscal and political unity.

That task is seen as slightly easier now that the crisis has evicted weak leaders from troubled euro zone countries like Italy and Spain. But it remains an uphill battle as Mrs. Merkel continued this past week to oppose the creation of bonds that would be backed collectively by the euro zone's members.

Politically, even the idea of a breakaway Greece is increasingly considered anathema. Despite expectations that Greece may need European taxpayer bailouts for as long as nine years, an exit could be calamitous, or even the exit of other countries from the euro union, officials fear.

While it would certainly be legally, financially and politically complicated for Greece to quit the euro zone, some banks are nonetheless tallying how euros would be converted to drachmas, how contracts would be executed and whether the event would cause credit markets to seize up worldwide.

GIANLUCA COLLA/BLOOMBERG NEWS

A UniCredit branch in Milan. The bank was one of several lenders on the Continent that have disposed of billions of euros in holdings of European government sovereign debt.

Royal Bank of Scotland is one British bank testing its capacity to deal with a euro breakup.

"We do lots of stress-test analyses of what happens if the euro breaks apart or if certain things happen" like countries being expelled from the euro, said Bruce van Saun, group finance director at the bank. He added: "I don't want to make it more dramatic than it is."

Certain businesses are taking similar precautions. The giant German tourism operator TUI stirred up a hornet's nest in Greece recently when it sent letters to Greek hoteliers demanding that contracts be renegotiated in drachmas to protect against losses if Greece were to exit the euro.

TUI took the action just days after Mrs. Merkel and President Nicolas Sarkozy of France, at a meeting of leaders of the Group of 20 leading economies in Cannes this month, acknowledged for the first time that Greece could well leave the monetary union. On Thursday, Greece's central bank warned that if the country failed to improve its finances quickly, the question would become "whether the country is to remain within the euro area."

In a survey published Wednesday of nearly 1,000 of its clients, Barclays Capital said nearly half now expect at least one country to leave the euro zone, with 35 percent expecting Greece to exit the union, and one in 20 expecting all five countries on Europe's periphery — Ireland, Greece, Portugal, Spain and Italy — to exit next year.

On Friday, Merrill Lynch issued a report exploring what would happen if numerous countries were to drop the euro and revert to their old currencies.

If Spain, Italy, Portugal and France were to start printing their old money again today, their currencies would likely weaken against the dollar, reflecting the relative weakness of their economies, Merrill Lynch calculated. By contrast, currencies in the stronger economies of Germany, the Netherlands and Ireland would probably rise against the dollar, according to the analysis.

In Asia, banks and regulators view the situation with growing alarm. Norman T.L. Chan, the chief executive of the Hong Kong Monetary Authority, said Wednesday that regulators had stepped up their surveillance of banks' exposure to Europe.

Regulators have been working with bank managers on stress tests to determine how the banks' financial stability might be affected in the event of increasingly severe financial dislocation in Europe, said a banker in Hong Kong who did not want to be identified because of the sensitivity of the issue and who declined to elaborate.

The main danger of a euro breakup, said Stephen Jen, managing partner at SLJ Macro Partners in London, is "redenomination risk," or the unpredictable effect that a euro breakup would have on financial assets as newly created currencies sought their own levels in the market and the value of contracts drawn up in euros came into question.

Most people hope that will not happen.

"Remember when Lehman went bankrupt? Nobody could anticipate what happened next," the French banker said. "That was a company, not a country. If a country leaves the euro — multiply the Lehman effect by 10."

Reporting was contributed by Keith Bradsher in Hong Kong, Julia Werdigier in London, David Jolly in Paris and Elisabetta Povoledo in Rome.

Market relief unlikely as E.C.B. sticks to its guns

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der any circumstances, the achievement of announced fiscal targets and deliver the envisaged institutional and structural reform programs," Mr. González-Páramo said in London on Friday.

Cheered on by Germany, E.C.B. policy makers have been consistent in arguing that huge purchases of government bonds would violate the bank's mandate and not solve the crisis in any case.

Mr. González-Páramo even accused investors of cynical self-interest when they plead for a European version of quantitative easing, the use of large purchases of securities to encourage economic growth.

"Market participants that call for the E.C.B. to play this role may care only about the nominal value of their assets and the need to avoid losses," he said in Oxford.

To outsiders it may seem that the E.C.B., located in Frankfurt and steeped in the conservative culture of the Bundesbank, would rather let the euro go up in smoke than compromise its principles. But policy makers do not see the choice in those terms.

To them, the best way to address the crisis is to stick to principles, the most important of which is preserving price stability. That is set out in the first sentence of the statute that defines the E.C.B.'s tasks. "The primary objective" of the European system of central banks "shall be to maintain price stability," the statute says.

Only three paragraphs later does the statute mention stability of the financial system, almost as an afterthought.

E.C.B. policy makers also believe that their charter forbids them from using bank resources to finance governments. If they expanded the money supply to provide debt relief to Italy, policy makers believe, they would be breaking the law.

They would also effectively be transferring the debt burden from countries like Greece and Italy to countries like Germany or the Netherlands, without any approval from citizens of those countries to do so.

In fact, the E.C.B. has been buying Italian government bonds and debt from other troubled countries, but in relatively modest amounts and always on the grounds that intervention was needed to maintain control over interest rates and prices.

Mr. González-Páramo argued this week that the restriction on E.C.B. action, far from a handicap, was a good thing. It helps policy makers resist the temptation to print money rather than make painful but necessary changes.

"The monetary financing prohibition, in this way, is a spur towards better policies and better governance — in other words, a closer economic union," Mr. González-Páramo said in the Oxford speech, which encapsulated arguments made by other top E.C.B. officials.

"Without any political signal they can't do it."

But there might still be a situation in which the E.C.B. would intervene massively in bond markets. The E.C.B.'s mandate is a two-way street. If there are credible signs that inflation is coming to a standstill, and that deflation threatens, the bank would have a strong justification for pumping up the money supply.

"Things would be very different if the E.C.B. started to think there is a risk of deflation," said Eric Chaney, chief economist of insurer AXA Group. "In that case there would be a good reason to buy bonds, to lower interest rates. Then it would be done for price stability objectives not for saving country X or Y."

But Mr. Chaney said the E.C.B. could not take that route until there was evidence that prices had turned negative. Inflation in the euro area is 3 percent on an annual basis, still above the E.C.B. target of about 2 percent.

The E.C.B., though formally immune from political influence, would in practice need the approval of European governments, especially Germany, to intervene. Any move would have to be tied to new treaty provisions to enforce greater spending discipline on governments in the future, said Daniel Gros, director of the Center for European Policy Studies in Brussels. "Without any political signal they can't do it," Mr. Gros said.

For the moment, opponents of greater bond buying on the E.C.B. governing council appear to hold sway. Jens Weidmann, president of the German Bundesbank and an influential council member, has been particularly vocal.

If there are members of the 23-member council who favor some form of quantitative easing, they have been quiet about it. But Mr. Gros said that support could grow as more countries see their borrowing costs soar.

Despite acute tensions on markets, policy makers argue that the crisis is not as acute as it seems, and they refuse to be rushed into making decisions they might later regret.

"Markets expect quick, bold and 'shock-and-awe' decisions on highly complex matters," Mr. González-Páramo said. "They are exasperated that something can be agreed by leaders but take months to enter into force. Yet this is a necessary condition of operating in a system of 17 sovereign democracies."

Good times for U.S. corporations

Floyd Norris

OFF THE CHARTS

In the six decades before the recent recession, there was never a period in which as much as 9 percent of U.S. gross domestic product went to companies in the form of after-tax profits. Now the figure is more than 10 percent.

During the same period, there never was a financial quarter when wage and salary income amounted to less than 45 percent of the economy. Now the figure is less than 43 percent.

For companies, these are boom times. For workers, the opposite is true.

The government's first estimate of corporate profits in the third quarter was released Tuesday. At the same time it revised G.D.P. growth in the quarter down to an annual rate of 2 percent.

The report on profits showed that effective tax rates, both corporate and personal, are well below the levels for most of the post-World War II era.

Corporate profits after taxes were estimated at an annual rate of $1.56 trillion during the quarter, or 10.3 percent of the size of the economy, up from 10.1 percent in the second quarter. Never until 2010 was there a quarter in which the corporate share was as high as 9 percent, as can be seen in the accompanying charts.

The government began calculating the quarterly figures in 1947, but it has annual figures back to 1929. Until last year, the record annual share was 8.98 percent, set in 1929. For all of 2010, the figure was 9.56 percent.

Compared with figures for the final three months of 2007 — as the 2007-9 recession was beginning — wage and salary income was up just 1.8 percent in the third quarter of this year. By contrast, overall corporate profits before taxes were 35 percent higher. With estimated corporate taxes just 1.5 percent higher, after-tax profits were up 49 percent. Those figures are in nominal dollars, not adjusted for inflation.

The corporate tax figures, which are estimates by the Bureau of Economic Analysis of the Commerce Department and are subject to revision, include state and local income taxes, as well as U.S. income taxes.

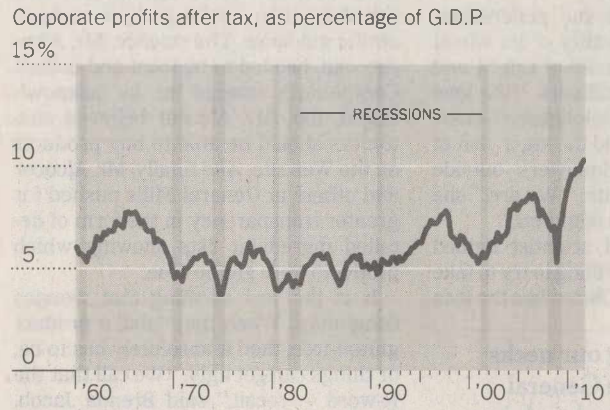
In the quarter, corporate taxes amounted to 21 percent of corporate profits, a figure that is lower than in all but two previous periods — the first two quarters of 2009, during the recent recession.

During the half century from 1960 through 2010, corporate taxes averaged almost 34 percent of net income, so the current figure is about a third lower than average.

Personal taxes as a proportion of total personal income was estimated at 14.1 percent for the quarter, with the tax figure including state and local income taxes, taxes on personal property and the employees' share of payroll taxes like Social Security. That figure is higher than it was in recent quarters but well below the 50-year average of 15.5 percent.

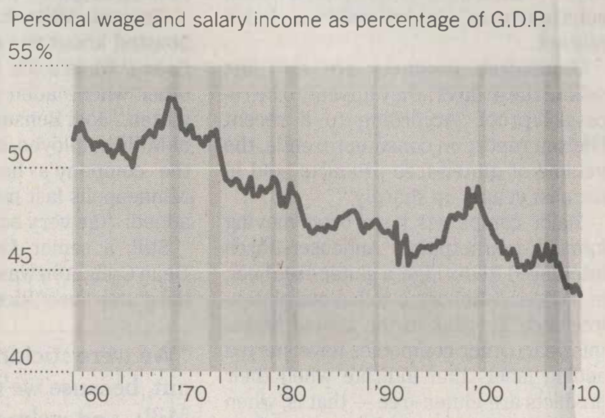
U.S. corporate profits hit record high . . .

Corporate profits after tax, as percentage of G.D.P.



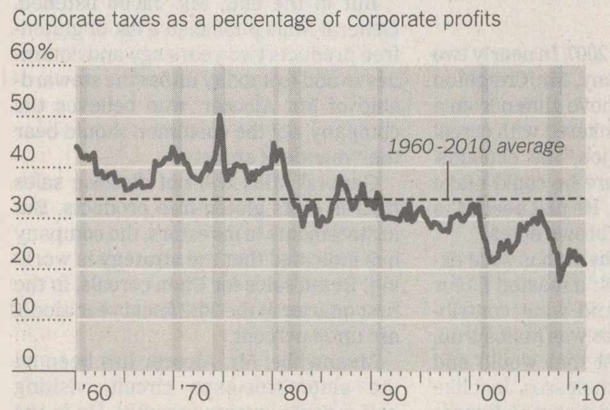
. . . as wages fall to new low

Personal wage and salary income as percentage of G.D.P.

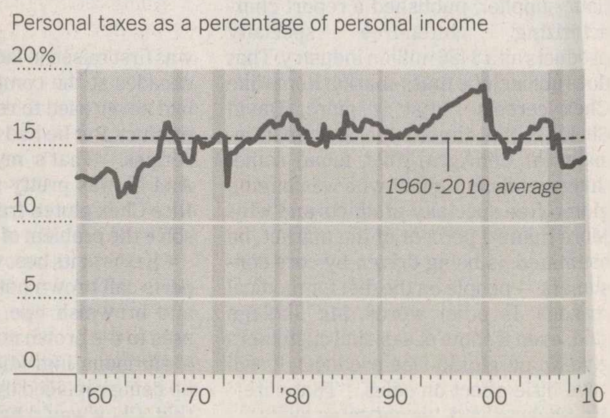


. . . and taxes remain well below average

Corporate taxes as a percentage of corporate profits



Personal taxes as a percentage of personal income



Note: Personal taxes includes state and local income taxes, taxes on personal property and employees' share of payroll taxes.

Source: U.S. Bureau of Economic Analysis, via Haver Analytics

For profit or charity? Foundations try for both

NEW YORK

BY STEPHANIE STROM

This year, the Bill and Melinda Gates Foundation invested $10 million to acquire a stake in Liquidia Technologies, a biotechnology company working on new ways to deliver vaccines.

The U.S. government requires that tax-exempt foundations pay out 5 percent of their assets each year on programs. A growing number are using such program-related investments, or P.R.I.'s, to connect with profit-making ventures. But as the investments become more popular, some officials in the nonprofit field worry that P.R.I.'s and other newer mechanisms are blurring the lines between profit-making businesses and charitable work.

The Liquidia investment was made from a $400 million program-related pool the foundation created in 2009. Now, the foundation is increasing that pool to $1 billion, a quarter of which will be used to make equity investments or to finance debt instruments in profit-making ventures.

The foundation's investment in Liquidia piggybacks on capital supplied to the company by traditional investors and is meant to ensure that the technologies the company develops for better delivery of vaccines not only benefit what Jeff Raikes, chief executive of the Gates Foundation, calls "the rich world" but also serve the poor, who are the foundation's beneficiaries.

"I'm not going to say we couldn't do this through a nonprofit, but it would certainly be more difficult," Mr. Raikes said.

Interest is growing rapidly in using P.R.I.'s to buy stakes in businesses that can help foundations achieve their missions, experts say, and the Gates Foundation alone will change the dynamics.

Diana Aviv, chief executive of the Independent Sector, the largest U.S. nonprofit trade association, said such investments reflected a broader trend.

"Foundations are increasingly agnostic about how they achieve their goals," Ms. Aviv said. "If their purpose is, say, to eliminate food deserts" — poor neighborhoods with little access to healthy food shopping — "they may see supporting a grocery store chain as the best way of doing that rather than funding a nonprofit program."

That trend concerns her at a time when government financing for nonprofit groups is declining and the charitable deduction is under fire. "It's part of this slow erosion of nonprofit funding streams that threatens to undermine organizations that have been built over decades to meet high standards of public trust," Ms. Aviv said.

Prospects dimming as millions of Americans stay out of work

ECONOMIC VIEW, FROM PAGE 8

$4.50 an hour for the lowest-paid workers, with declining amounts until they earn more than $15 an hour. Unlike the current "earned income tax credit," his plan would not be biased toward families with dependent children, but would apply equally to all workers.

He estimates that the current cost of such a program in the United States would be about $150 billion a year — equivalent to about 1 percent of gross domestic product. The program would be well worth the expense.

The American Jobs Act proposed by President Barack Obama in September includes subsidies in the form of re-employment services, wage insurance, work-sharing benefits and self-employment assistance. Stephen A. Wandner, a fellow at the Urban Institute, who also does research for the W.E. Upjohn Institute for Employment Research, testified before the Senate Finance Committee this month and offered a number of other ideas that have been successful on an experimental basis. Among them are comprehensive job search assistance and re-employment bonuses.

The stakes are very high here, and they are not just economic. As anger rises in the current economic background, I am reminded of Thomas Jefferson's words about the danger of "angry passions" arising between the North and South over the question of extending slavery to the Missouri territory. In an 1820 letter, he wrote that "this momentous question, like a fire bell in the night, awakened and filled me with terror." He went on to predict, from his observations of such rancor, the Civil War that was to come 40 years later.

The United States is a much more stable society now than it was in 1820. Still, it should regard the current economic dispute as another fire bell in the night. It is important to recreate the sense of a just society, without anger — and an important step in that direction is to ensure that there are enough jobs.

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