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Divided E.U. tussles over a rescue plan for its own

FRANKFURT

A line is drawn over idea of committing to a pool of common euro zone debt

BY JACK EWING AND PAUL GEITNER

To euro zone countries in need, euro bonds would be a noble expression of European solidarity and a crucial instrument for preserving the common currency.

To Germans and quite a few others, though, euro bonds would be a lot like

NEWS ANALYSIS

co-signing a loan for a deadbeat brother-in-law.

Those caricatures have dominated a debate that has left Europeans deeply divided on a central question: Should euro zone countries create common bonds to reduce borrowing costs for members that cannot get affordable credit on their own?

But despite the intensity of the debate, even as political upheaval in Greece and bad bank loans in Spain mushroom into existential threats to the currency union, the euro bond remains only the vaguest of concepts.

About the only thing clear is that Germany and some other creditworthy northern countries oppose adopting such bonds anytime soon. Meanwhile, François Hollande, the new French president, seems keen on speeding things up — even if he has not quite articulated how his idea would work.

"You don't know what François Hol-

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ELECTION WARNING TO GREEK VOTERS
The Socialist party leader told Greeks that repudiating a bailout agreement would be "catastrophic." *PAGE 14*

SPAIN'S SMALL FIRMS LOSING CREDIT
Spanish banks are reducing lending to hundreds of small enterprises, putting many of them out of business. *PAGE 15*

SHAAM NEWS OPPOSITION NETWORK, VIA AGENCE FRANCE-PRESSE

An image provided by the Syrian opposition showed bodies ready for burial in Houla after fighting Friday and Saturday. Rebel groups said Syrian tanks had pounded the town.

Betting on euro breakup, with hard cash

NEW YORK

Web site sees 42% odds that Greece will exit bloc before the year is out

BY JEFF SOMMER

Intrade is an online betting site with an enviable record for predicting Oscar winners and political events. It has gotten the past two American presidential elections right. Now it is wading into the perils of the euro zone.

The long-running European crisis has already turbulent financial markets around the world, with investors shifting away from riskier assets like stocks and parking their money in havens like German, Swedish, Dutch and U.S. government bonds, whose yields are now extraordinarily low.

Just about everyone agrees that in the past month, the chance that Greece will abandon the euro has risen, with consequences that could be much more disruptive. European leaders meeting in Brussels on Wednesday failed yet again to come up with an enduring solution.

But how high is the probability of a euro breakup? Intrade says it is about 40 percent.

More precisely, as of Friday, Intrade assessed the probability that Greece — or some other country — might announce its intention to drop the euro by the end of the year at 41.7 percent. It rises to 60 percent for a breakup by the end of 2013, and to 68.7 percent by the end of 2014.

How seriously should these projections be taken?

"The numbers on Intrade are an incredibly quick and useful way of figuring out what the average expert opinion is on a given subject," said Justin Wolfers, a visiting professor of economics at Princeton, who had studied Intrade and other prediction markets. While "most political discourse is qualitative — you say, 'this is likely to happen for these reasons' — this is quantitative," he said. "You've got a number, and a pretty good number at that."

Intrade is based in Dublin, though many of its traders live in the United States. People bet on contracts stating

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Debt rescue plan deeply divides E.U.

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lande is talking about when he talks about euro bonds," said Jacques Delpla, a member of the French Council of Economic Analysis, a panel that advises the government. "An open bar with German money for Greece and Spain? That doesn't work."

At their meeting in Brussels last week, European Union leaders agreed only that euro bonds deserved further study.

Mr. Delpla is the co-author, along with a German economist, Jakob von Weizsäcker, of one of the few detailed proposals so far. They outlined how euro bonds might be used to ease financial pressure on countries like Greece, Spain or Italy while addressing German concerns by encouraging more prudent government spending.

The basic idea of euro bonds does enjoy wide support among economists. Proponents also include Christine Lagarde, managing director of the International Monetary Fund. And last week the Organization for Economic Cooperation and Development in Paris called for some variation of euro bonds.

The various models share a basic idea: In addition to each country's raising money by issuing its own bonds, as is now the practice, they would put at least some of the debt into a common pool. These pooled bonds would be issued by some kind of joint European debt agency, with all members assuming shared responsibility for repayment.

There is no agreement yet on whether that pool would be used to replace existing debt or to finance new borrowing. Nor is it clear how countries would have access to the money raised by the sale of the bonds.

Surprising as it may seem, the euro zone's total government debt actually is lower as a proportion of annual gross domestic product — 87 percent — than that of the U.S. government, which is more than 100 percent of G.D.P.

A reason euro zone debt has reached crisis proportions is that a few countries in Southern Europe owe too much money and have lost the faith of investors.

The United States so far is able to stay a half-step ahead of its debt because it can keep selling Treasury bonds. Investors worldwide are so certain of being repaid that they accept interest rates of less than 1.75 percent for a 10-year Treasury bond.

Right now, though, the weakest euro zone members have no such credibility with creditors. So Spain must pay more than 6 percent on its 10-year bonds, while investors last week were demanding 5.6 percent for Italian bonds. And about the only ones willing to lend to Greece these days are Europe's bailout institutions and a few roll-the-dice hedge funds.

But if euro zone countries threw their bonds into the same pot, the argument goes, they could create a debt market rivaling that for U.S. Treasury securities — and greatly improve the chances that Spain and Italy could continue to make interest payments and avoid default or a Greek-style debt overhaul.

That is why, as Greece edges toward an exit from the euro zone, and Spain wrestles with its expanding bank crisis, many analysts see euro bonds as unavoidable.

"If we don't have common bonds very soon, in the next year or so, southern European countries will go bankrupt," Mr. Delpla said.

The problem is that talk of euro bonds inevitably raises fundamental ques-

GEERT VANDEN WIJNGAERT/AP

Chancellor Angela Merkel is among the skeptics of a quick fix from euro bonds.

tions about the nature of the European Union. Such bonds would require European countries to watch one another's spending much more closely, and each country would have to cede some control over its own budget.

For euro bonds to work the way U.S. Treasury securities do, investors would need assurances that they are backed by a central treasury, or at least an agency with direct access to tax revenue from each member state.

"This needs a very strong institutional setup," said Guntram B. Wolff, deputy director at Bruegel, a research organization in Brussels. "If you are going to sell them to a Singaporean investor, the Singaporean investor needs to know who is going to pay that bond."

Once European governments began financing one another on a large scale, they would certainly also want more say over one another's budgets and big-ticket items like military spending or pension systems. For those who advocate a more powerful "United States of Europe," these changes would be good. But they would represent a huge transformation of the decentralized Europe that exists today.

"Immediately behind the euro bond proposal lurks political union," said Uri Dadush, a director at the International Economics Program at the Carnegie Endowment for International Peace in Washington.

"The moment you start saying, 'Give me half your tax receipts,' we are talking serious stuff," Mr. Dadush said. "We are talking about giving up major sovereignty."

The European Central Bank probably has the credibility to play the role of a euro bond debt-issuing agency. But the bank would almost certainly refuse to do so, seeing it as a threat to its political independence — and a violation of the prohibition on using the bank to finance governments.

But even if the E.C.B. did not issue the debt itself, euro bonds would need at least the central bank's tacit support, Mr. Dadush said.

A big reason U.S. Treasury securities have retained credibility with investors, for example, is that despite official denials of complicity, there is an assumption that the Federal Reserve would not let the U.S. government go bankrupt. The E.C.B. would probably be much less likely to accede to such an implicit guarantee.

The German chancellor, Angela Merkel, made an argument similar to Mr. Dadush's at last week's meeting in Brussels, saying Europe must become more economically and politically integrated before it could issue common debt. But the federal Europe she seems to have in mind could take years to build, by which time the euro could lay in ruins.

Germany also fears that lower interest rates would simply reinforce irresponsible spending habits by countries like Italy. To German eyes, Italy, Greece and others did not take advantage of the low interest rates available in past years to make their economies function better.

In a short statement to the news media after the Brussels meeting, Ms. Merkel said "several participants noted that the common interest rates with the introduction of the euro really didn't lead to improvements in the economic competitiveness of all the euro countries."

Economists have proposed several ways around that problem. The model by Mr. Delpla and Mr. von Weizsäcker, for instance, would let countries put some of their debt — equal to no more than 60 percent of gross domestic product — into so-called blue bonds issued by all members. These would presumably carry a very low interest rate.

The rest — the red bonds — would remain the responsibility of individual countries and would probably carry much higher interest rates.

Countries would need approval from a central committee to issue blue bonds, and could do it only if they followed responsible economic and budgetary policies. Germany would effectively have veto power.

"If you behave well, you have access to blue debt," Mr. Delpla said. "If you start to behave like Berlusconi, you will not have access to blue debt, and the price of red debt will go up." He was referring to the former Italian prime minister, Silvio Berlusconi, whose policies were blamed for much of Italy's current economic and debt woes.

Thus Spain and Italy would still feel acute pressure to improve the way their economies function and to get better control of public spending. One big advantage of the proposal, Mr. Delpla said, is that it could be put into action quickly without a major restructuring of the European Union.

European leaders are certainly aware of the blue bond/red bond proposal. Mario Monti, Italy's current prime minister, is a former head of Bruegel, the research group that originally published it. But top European policy makers are still far away from approving any euro bond model.

Another of the most influential proposals actually came from the heartland of euro bond opposition. The German Council of Economic Experts, a group of independent economists who advise the government, late last year proposed pooling all of Europe's debt overhang, defined as the amount above 60 percent of G.D.P.

Under this plan, countries would get rid of their excess debt — about €2.3 trillion worth, or $2.9 billion — which would be paid off over 25 years. But after that, governments would have to keep debt below 60 percent of G.D.P. That is the limit they agreed to — but have not observed — when they formed the currency union.

So far, Ms. Merkel has expressed support only for so-called project bonds — joint debt used to finance roads or other infrastructure that might benefit all Europeans. Economists agree, however, that project bonds would not do much to stimulate growth across Europe, much less solve Spain's banking crisis or reduce Italy's borrowing costs.

Although leaders agreed in Brussels to study euro bonds more closely, the process is moving slowly. Herman Van Rompuy, president of the European Council, plans to come back to the leaders at the end of June with a first look at the "building blocks" for moving toward projects like euro bonds. He plans first to consult with the E.C.B., the European Commission and the president of the Eurogroup of euro zone finance ministers.

One European diplomat, speaking on condition of anonymity, said even a step toward euro bonds could reassure investors who have been watching Greece teeter and fear a bank run in Spain — and wondering what happens next. "The fundamental issue," he said, "is who or what stands behind the euro."

Paul Geitner reported from Brussels.

PHOTOGRAPHS BY MARTA RAMONEDA FOR THE NEW YORK TIMES

Iván Moreno recently laid off almost all the employees at his skateboard company after his bankers effectively closed his roughly €200,000 credit line, strangling his young business.

Spain's plight worsens as small firms lose credit

ZARAGOZA, SPAIN

BY SUZANNE DALEY

There was a time when Iván Moreno, 34, felt he was on the verge of something big — when it seemed right to settle his rapidly expanding skateboard company into a modern warehouse on the outskirts of this city, when orders piled up from stores around the world.

Those days are gone.

Like the owners of many small and midsize companies in Spain, he is just struggling to stay alive now, a victim, he says, of the deep restructuring of Spain's banking sector after the collapse of the real estate bubble in 2008. Mr. Moreno said his bankers closed his roughly €200,000, or $250,000, credit line step by step, imposing harsh repayment plans and effectively strangling his young business.

"So many times, I went to the bank and said, 'What did I do wrong?'" said Mr. Moreno, who recently had to lay off almost all of his employees, including a childhood friend. "But they just said they wanted their money back."

Experts say that what happened to Mr. Moreno is happening to small companies all over Spain, as many of the regional savings banks that such businesses once relied on are being eliminated or swallowed up in a series of steps intended to deal with the hundreds of billions of euros in bad loans from the real estate meltdown.

Whether the strategy is working remains an open question. Moody's Investors Service recently d graded more than a dozen Spanish banks, including the two largest, and on Friday, a major bank warned that it would need an additional €19 billion in aid, far beyond what the government estimated when it seized the bank this month.

But experts say there is little doubt that the loss of credit is hurting smaller businesses, contributing to Spain's troubles by raising unemployment and cutting tax revenue, making it harder to bring its budget deficit down to manageable levels. The credit loss hits particularly hard in Spain, where more than 60 percent of the economy, and 80 percent of the jobs, come from small and midsize companies. More than 500,000 small businesses have shut down in the past few years.

Mr. Moreno said that one year his company, Nomad Skateboards, sold more than €1 million worth of skate-

The window of a Colores shoe shop in central Zaragoza, Spain. The chain's owner, Charo Albás Vives, has closed 13 of 25 stores since her bank withdrew a €50,000 credit line.

boards and accessories in 20 countries. These days he is looking for a buyer for his warehouse and trimming his product line to just skateboards and T-shirts. "If you cannot buy, you cannot sell," he said. "If you cannot sell, you cannot make a profit."

Many are done in by their inability to get the credit they need to run day-to-day operations. "The savings banks that these people got their loans from don't even exist anymore," said Alfonso García Mora, director general of AFI, a financial consulting firm in Madrid. "T e banks have been taken over by bigger banks that aren't interested in these kinds of loans. Or they have been taken over by banks in another region, where the local businessman is not known."

Such changes might be felt for years to come.

"We have lost that local knowledge," Mr. Mora said, "and it was crucial to deciding whether or not to make a loan. It is a problem we will have for a long time."

A few years ago, Spain had 45 regional savings banks. Today, there are only 13 and even their future is uncertain. Some have been merged with other banks and others have been taken over by bigger, more robust banks as part of efforts to reassure global markets.

Many business owners say the regional bankers they worked with, sometimes for decades, may still be sitting in their chairs at the local office. But they no longer have the power to approve loans, even if they wanted to, and usually they are just delivering bad news.

That means trouble in a country with 25 percent unemployment and no signs of an economic recovery. The warehouse district that is home to Mr. Moreno's company is virtually deserted these days. Charo Albás Vives, who owns a children's shoe company, Colores, is in similar straits. Her bank withdrew her €50,000 credit line two years ago.

At first, she said, the bank wanted her to return only half of it. But after she

"How are you going to get new businesses going if there is no one willing to take a risk and lend you money?"

managed that, the bank told her that she would have to repay the rest, starting immediately.

Ms. Albás, who has six children, said the payments required her family to make all sorts of economies. "We stopped going to the good grocery store," she said. "We cut back on everything, even the heating."

It also meant that she could no longer afford the brightly colored inventory her stores were famous for. "We concentrate on white and blue now," she said.

She has survived, she said, thanks to loans from her family, though 13 of 25 stores have closed.

Before the crisis, experts say, it was probably too easy to get loans; banks operated with too little equity and lent too much. Regional banks, in fact, made many of the most problematic loans to real estate developers. Now, as the banking sector struggles for survival, lending to private companies and households has dropped precipitously.

"The cuts in credit have been so abrupt that some businesses not only lost specific projects they were working on," said Carlos Ruiz Fonseca, the director of economy and innovation at Cepyme, Spain's association of small and midsize companies. "Some companies have just gone out of business."

Despite the mergers and injections of capital from the banking bailout and reconstruction program begun by the government in 2009, there has been no improvement in lending. According to the Bank of Spain, credit to the private sector fell in March, as it has virtually every month since the autumn of 2009. Some businesses say they do not even bother asking for loans anymore.

Getting loans to start a company may be even harder. "How are you going to get new businesses going if there is no one willing to take a risk and lend you money?" said Edward Hugh, an economic guru who writes a blog about the Spanish economy. "The problems become circular and self-perpetuating."

Some companies have found innovative ways to do business without credit. Emilio Díaz, for instance, who founded a bus and train window factory in Zaragoza in 1969, said that rather than borrow to cover the cost of glass for a big contract, he recently made an agreement with his supplier to pay for the glass after he was paid for the windows.

Other companies have found that doing business with several different banks helps. Olga Rioja Navarro, the financial director of Lacasa, a chocolate manufacturer that has lost 20 percent of its credit line, says she juggles her business among nearly a dozen banks.

Mr. Moreno and his partner, Chus Castejón, hope they can find a private investor. But they fear that their brand will lose hard-to-reclaim momentum in the fashion-conscious world of skateboarding. "Sometimes you have your moment, and then you can't get it back," Mr. Castejón said. "And that makes me so angry."

Rachel Chaundler contributed reporting.

Betting site handicaps a Greek withdrawal from euro

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that a particular event will take place by a given time, and have traded more than $68 million worth of contracts this year, according to Carl Wolfenden, exchange operations manager for the Web site.

Like stock or bond prices, its predictions, often expressed as probabilities, are derived by matching buyers and sellers. The probabilities are intended to embody the aggregate information of the market — the "wisdom of crowds," as the author James Surowiecki has called it.

The pricing mechanism used by Intrade is "virtually identical" to that of mainline financial exchanges, Mr. Wolfers said. The site's projections are imperfect, but, he added, "empirically, they have been better than the alternatives" like opinion polls and individual expert opinion.

To put the projection of a euro breakup into context, it has a slightly higher probability than the one Intrade lists for Mitt Romney's chance of being elected president in November, standing at 39.4 percent as of Friday. At the same time, the site gave President Barack Obama a 57.1 percent chance of re-election.

There is no evidence that Intrade is being widely used to handicap events that are important to financial markets, but it is not being entirely ignored either. Ned Davis Research, a financial research firm based in Venice, Florida, has included charts of the Intrade Greek probabilities in recent reports.

"They correlate very closely with the flight to safety in the sovereign bond

"You've got a number, and a pretty good number at that."

markets," said Will Geisdorf, a senior research analyst for the firm, which also relies on many other indicators that suggest deep pessimism and "high fear readings" among investors.

Analysts using other indicators share the view that the euro crisis has unmoored many markets. Largely because of Greece and the euro quandary, for example, Deutsche Bank predicted in a report last week that the yield on the 10-year U.S. Treasury note, which dropped to a low of 1.698 percent this month, could tumble below 1.5 percent this year. Robert P. Brown, president of the bond group at Fidelity Asset Management, said in an interview that "if the Greek issue isn't resolved," he would not be surprised if yields fell below current levels, perhaps even below 1.5 percent.

Falling bond yields — and rising bond prices — have been accompanied by a weak stock market, a reversal of the traditional pattern, Ed Yardeni, an independent economist, wrote recently. "Prior to the financial crisis that started in 2007," he said, "falling bond yields tended to be associated with rising valuation multiples in the stock market. The relationship has been reversed since then."

The primary reason has been fear of contagion from a financial collapse, originally in the United States and, in recent months, in Europe. The U.S. Federal Reserve, the European Central Bank, the Bank of England and other central banks have deliberately lowered interest rates, but the sinking yields of relatively safe government bonds in recent weeks have overshot the expectations of most investors.

Hedging against the risk of a profound disruption helps explain the premium being paid for these low-yielding assets. And, at the moment, the Greek election on June 17 is being widely viewed as a pivotal event.

If that election results in a government that rejects bailout terms that have already been imposed, a Greek exit from the euro zone could follow.

Some strategists see these concerns as overblown. James W. Paulsen, chief investment strategist at Wells Capital Management in Minneapolis, for example, said he believed that the problems of the euro zone would persist for years, but that they were manageable. And he said that compared with the performance last year, the stock market's response to euro zone stress is far more restrained. U.S. economic data are stronger than has been widely appreciated, he said, and the stock market "could easily rebound."

It's time, he said, "that we learn that these euro crises are buying opportunities, not a time to sell."