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Spectre of default rises again in Congress

US nears $16.4tn borrowing limit

Speaker demands cuts to spending

By James Politi and Stephanie Kirchgaessner in Washington

The Republican leader of the House of Representatives has set the stage for a new fiscal showdown with the Obama administration, reviving memories of the standoff last summer that saw the US lose its triple A rating.

In a speech yesterday, John Boehner, Speaker of the House, warned the White House that Congress would authorise a rise in the government's ability to borrow only if it were matched with equal amounts of spending cuts.

"This is the only avenue I see right now to force the elected leadership of this country to solve our structural fiscal imbalance," Mr Boehner told a US fiscal policy summit, according to excerpts of his prepared remarks. "We can make the bold cuts and reforms necessary to meet this principle, and we must."

After protracted talks last year, Congress and the White House struck a deal that allowed US borrowing authority to be increased to $16.4tn, just hours before the US was due to default on its government bonds. The fraught nature of the talks triggered a downgrade of US debt by Standard & Poor's, the rating agency, and exacerbated concerns – on Wall Street and worldwide – about the functionality of the political system.

Mr Boehner's stance will raise fears this showdown will be repeated in 2013, raising the stakes in the battle over tax and spending policy that is defining the presidential race. The move also ratchets up the pressure in fiscal talks that will have to take place after the November election.

As well as increasing the US debt ceiling, Congress will have to decide the fate of expiring Bush-era tax cuts and automatic defence cuts and domestic spending. Without action, the US will be hit by fiscal contraction that could halt recovery. The $16.4tn borrowing threshold will be reached later this year, but the Treasury department will be able to push back a default on government securities by using cash management measures.

Tim Geithner, US Treasury secretary, said: "We hope [members of Congress] raise the debt limit this time without the drama and the pain and the damage they caused the country last July."

US fiscal policy is a pivotal issue in the contest for the White House between President Barack Obama and Mitt Romney. Mr Obama wants to raise taxes on the wealthy and limit spending reductions. Republicans are opposed to new levies and instead propose aggressive cuts to popular government programmes.

In Iowa yesterday, Mr Romney was due to say: "A prairie fire of debt is sweeping across Iowa and our nation and every day we fail to act we feed that fire with our own lack of resolve." By insisting that a debt limit rise is tied to matching spending cuts, Mr Boehner is issuing a challenge to Mr Obama if he is re-elected. But it could also prove awkward for Mr Romney if he wins the White House and no deal is reached before his inauguration, thus leaving the former Bain Capital executive with the hot potato of a US default after taking office.

At the end of last year's talks, the size of the debt ceiling increase – $2.1tn – was matched by spending cuts of $2.1tn over 10 years. Even so, Mr Romney – then in the early stages of his campaign for the presidential nomination – refused to back the deal.

One Democratic aide in the Senate said Mr Boehner's move represented an effort to tilt the balance of the end-of-year talks in his party's favour. "The debt ceiling increase is the one thing Republicans will act like Democrats want and they will try to use it for leverage to protect their interests on sequester [the automatic spending cuts] and taxes," he said.

Martin Wolf, see Comment

Round two?: The fraught nature of last year's talks triggered turmoil on Wall Street Reuters

US consumer prices steady

US consumer prices held steady in April, in line with estimates, as falls in fuel costs offset rising prices of food, clothing and housing, **writes Anjli Raval**. The core consumer price index, which excludes more volatile food and energy costs, edged 0.2 per cent higher, also as expected, according to labour department statistics.

In March, CPI had risen 0.3 per cent as the cost of food and petrol continued to climb; core CPI rose 0.2 per cent.

April's easing was driven by petrol prices, which fell 2.6 per cent, the biggest drop in six months. Food prices and housing costs edged up 0.2 per cent.

Against April 2011, headline prices rose 2.3 per cent, while core prices were 2.3 per cent higher.

US retail and food services sales rose 0.1 per cent to $408bn, as analysts had forecast. The rise was slower than the March increase of 0.7 per cent, but sales were 6.4 per cent above April 2011.

Read the full story at www.ft.com/us

Young put off buying homes under weight of student debt

US housing market

Loan burdens and tighter mortgage rules are restricting the number of first-time buyers, writes **Anjli Raval**

Andrea Stautberg and her husband James wanted to buy a house after finishing postgraduate courses in 2009. But in the face of a tough economic climate, uncertain job prospects and $115,000 in student loans, they decided to save money instead by living with James's parents in Texas.

The couple stayed for more than a year – longer than the three months they had planned – before deciding to rent a flat.

"We're looking to buy a house but have yet to get pre-approved," said Ms Stautberg, 27. "We lived with his parents for as long as we did to pay back our student loans and still save for a downpayment."

Their story illustrates how hard it has become for young people to buy their first homes, despite low interest rates and years of falling US house prices. The number of first-time buyers has plunged – they comprised 37 per cent of home purchases in 2011, down from 51 per cent in 2010 – sapping the struggling housing market of a traditional source of vitality.

High levels of student debt, along with tighter mortgage requirements and stagnant wages, are forcing young people to delay buying their first homes. Concern about rising student debt levels is growing and Barack Obama has sought to make it a presidential election-year topic.

At more than $1tn, outstanding student debt has overtaken car loans and credit cards as the second largest source of US consumer debt after home mortgages, official data show. Recent graduates carry an average debt load of more than $25,000 – a burden that may hamper their ability to qualify for a mortgage.

First-time buyers – usually aged between 25 and 34 – are an important source of housing demand because they form the start of a chain of housing deals. The reduction in demand for "starter homes" has left owners who want to move on to bigger homes in a bind, as the pool of people willing to buy their properties has shrunk.

Even though single family homes are the most affordable since records began in 1970 – with prices down a third from their 2006 peak – young adults are renting, not buying.

Many, like the Stautbergs, moved back home. Almost 6m people aged between 25 and 34 lived with their parents in 2011, up from 4.7m when the recession hit in 2007, official statistics show.

Brad Doremus, senior analyst at Reis commercial real estate research, said first-time buyers were hurt by tighter mortgage requirements that were harder to meet because of student debt burdens.

"Downpayments needed to buy a house have grown since the years of loose mortgage credit in the mid-2000s. Back then, many buyers were able to purchase a house with no money down. Now, a 20 per cent downpayment seems to be the norm. As a young, first-time buyer, that amount can be onerous," he said.

$1tn+

Student debt – now second largest sum after mortgages

Roshell Schenck, 28, from Erie in Pennsylvania has a pharmacy doctorate and earns $125,000 a year – but is unable to own a home.

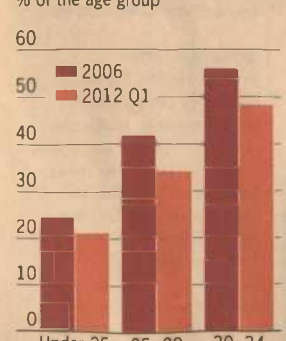
She said: "Between undergraduate and doctorate schooling and interest, I now have approximately $120,000 in loans. Although I make a very good salary, there is no government help for housing programmes because of the amount of money I make, and there is no one willing to give me a loan because of the amount of student debt I have."

Student debt rose a quarter for the average borrower for private schools and 11 per cent for state schools during the 2000s, says the College Board, which promotes access to higher education. A recent survey by Rutgers University showed 40 per cent of graduates questioned had delayed buying a big item such as a home or car because of student debt. More than a quarter had put off continuing education.

Over the same period, median household incomes, when adjusted for inflation, have dropped about 7 per cent. And young people's pay has suffered amid high youth unemployment.

US home ownership rates

% of the age group



Source: US Dept of Housing and Urban Development

Athens braced for fresh election

Parties fail to form unity government

Bank shares hit for second day running

By Kerin Hope in Athens and Robin Wigglesworth in London

Greece is heading for a fresh general election after its political parties failed to form a national unity government because of opposition from the anti-bailout Syriza coalition.

President Karolos Papoulias, who chaired three failed meetings with political leaders in as many days, was unable to bridge differences between Syriza and the two pro-euro parties, the centre-right New Democracy and PanHellenic Socialist Movement (Pasok).

A caretaker government will be chosen today to oversee the election, expected on June 17.

The prospect of a stronger electoral backlash against the terms of Greece's rescue programme in a second election, potentially jeopardising the cash-strapped country's euro membership, roiled financial markets.

European bank shares were hammered for a second day running as the FTSE Eurofirst banking index slumped below its 2009 financial crisis nadir to the lowest since at least 2004, when the measure started.

Italian and Spanish benchmark 10-year bond yields climbed, to 5.83 per cent and 6.3 per cent respectively, as investors fretted that uncertainty over Greece could infect larger, more systemically important eurozone members.

"Unfortunately, the country is on the road to elections under very negative conditions," said Evangelos Venizelos, the Pasok leader, after an acrimonious two-hour meeting at the presidential mansion.

The socialists finished third in an inconclusive election on May 6 after voters abandoned them in droves for Syriza, which pledges to reverse wage and pension cuts imposed under Greece's second €174bn bailout programme and reduce unemployment by hiring 100,000 additional civil servants.

Greece faces deepening political instability as the second election is also unlikely to produce a clear result. Christine Lagarde, managing director of the International Monetary Fund, warned a Greek exit would be "quite messy".

She said that while the fund hoped it would not happen, "we have to be technically prepared for anything".

> 'The country is on the road to elections under very negative conditions'

Alexis Tsipras, the Syriza leader, accused the pro-euro parties of trying to blackmail voters into supporting further austerity measures, saying his party would "not betray the hopes and expectations of voters who rejected the bailout". Some 70 per cent of votes cast in the previous election went to anti-austerity parties.

An opinion poll by Rass, the pollster, on Monday indicated that Syriza would finish first in the next election, increasing its share of the vote from 16.8 per cent to 20.5 per cent.

Yet 54 per cent of respondents said Greece should continue to implement reforms agreed with the EU and IMF to stay in the euro.

Several Athens bankers voiced concern over a sustained outflow of deposits of more than €5bn since May 6, reflecting increased political uncertainty.

Deposit levels have fluctuated during the two-year crisis, yet about €2bn returned to the banks in March and April after international lenders agreed to provide €40bn of funding for their recapitalisation.

Calculations by Barclays showed the economy expanded in the first quarter compared with the previous three months. But gross domestic product was still more than 6 per cent lower than a year before.

Tremors in the union

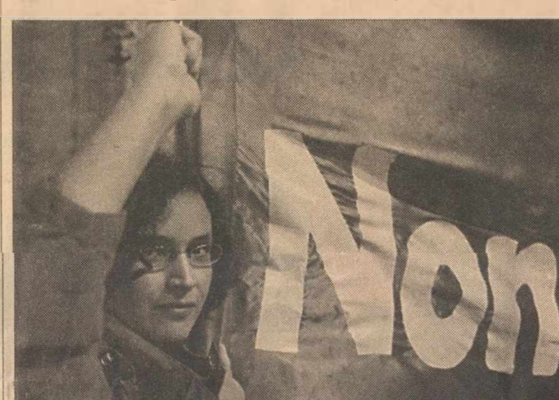
Pics: Getty/PA

2012 Greek drama

Anti-austerity feeling and political turmoil raise questions over Greece's continued membership of the eurozone

1992 Setback for single currency

Norman Lamont, UK chancellor, announces Britain's exit from the exchange rate mechanism. Italy also leaves



2005 Constitution blow

France and the Netherlands reject the EU constitution, raising fears that voters no longer wanted closer union

Focus turns to extent of contagion as 'little country' threatens big impact

FT series
If Greece goes . . .

Some say a Greek euro exit would heal a wound so integration can go on, but others fear it could be just the first to fall, write **Peter Spiegel** and **Quentin Peel**

For more than 20 years, Jean-Claude Piris was one of the most powerful men in Brussels, a top EU lawyer who almost single-handedly authored the series of international treaties that took a loosely affiliated community of 12 to a quasi-political union of 27, complete with its own currency.

So when Mr Piris retired last year and published a book arguing the EU had grown too large too quickly, it set off a firestorm among the eurocracy. "To blame us for the imprudent lending within the eurozone, we just find that offensive nonsense," said a senior minister from a newer, central European member state.

But Mr Piris' theory that the EU should develop a "hard core" among a smaller, more integrated group of eurozone countries could soon be put to the test. If Greece were to exit the euro, Mr Piris believes, other member states would be forced to integrate their economies and fiscal institutions even more closely to fend off the inevitable attack from panicky markets.

"If the Greeks leave, the reaction of people in charge – the intelligentsia and groups of leaders and partners – will be towards . . . a more unified monetary union," Mr Piris said in an interview. "It's the only solution to convince the markets."

Mr Piris' view is not universally shared. For every EU insider who views a potential Greek euro exit as a chance to cauterise a festering wound and press on with the postwar push towards greater integration, there are at least as many who fear Greece could be the first of several dominoes to fall – not only from the euro, but potentially from the EU itself.

"The big question is whether all those who talk about a Greek exit not only fully understand the potential economic consequences, but whether they have plans ready to control the huge political fallout that could ensue in Europe," said one EU diplomat. "The die is not yet cast."

The process of European integration has suffered frequent setbacks that at the time appeared to question its inevitability.

In 1965, President Charles de Gaulle refused to send French ministers to Brussels meetings, an "empty chair" policy that brought the nascent community to a halt. Nearly 30 years later, Britain and Italy were forced out of Europe's exchange-rate mechanism, a nearly fatal blow to a future single currency. And a decade after that, France and the Netherlands rejected a new EU constitution, raising worries Europe's voters no longer viewed a closer union as an attractive goal.

But integration only briefly stalled. Greece's euro exit, on the other hand, would be the first full reversal, and it comes at a time when the EU's unpopularity – previously episodic or isolated to a few countries – has become a continent-wide phenomenon, with Eurosceptic populists gaining ground from Finland to France.

"In the past, the system was very resilient. Typically, people found pieces of sticking plaster very quickly," said Helen Wallace, a leading EU scholar at the London School of Economics. "In looking for sticking plasters and ways that will stabilise today, the temptation to do it with a smaller number of member states becomes greater and greater."

Ulrike Guérot of the European Council on Foreign Relations, added: "A process of disintegration acquires its own dynamics."

José Manuel Barroso, president of the European Commission, has repeatedly urged national political leaders to more aggressively challenge anti-EU sentiment given fresh impetus by the Greek crisis in northern member states – where resentment towards ever larger bailouts has seen anti-EU parties gain a quarter to a third of the vote in recent Dutch and Finnish polls – and the beleaguered southern periphery.

"I can handle Euro-sceptics," Mr Barroso said last week. "The real problem is the depressive attitude of pro-Europeans."

But much as financial contagion spread from Greece to other eurozone peripherals last year, some officials fret that Alexis Tsipras, the radical left Greek leader who has surged in the polls by thumbing his nose at Brussels, could serve as a model to other populists, causing political contagion through the EU.

As with most issues that have consumed the eurozone over the past two years, most officials and analysts believe the ultimate political judgment will fall on Angela Merkel, the German chancellor, who has in recent days moderated her hardline rhetoric towards Athens.

Mr Piris said that rightly or wrongly, a Greek exit will be seen as Ms Merkel's doing and could well be her historical legacy – a difficult verdict for any German leader given that the EU's foundations were built on agreements aimed at curbing German militarism.

"Politically, is Ms Merkel going to present herself as the one who let the EU go away?" asked Mr Piris.

Within Germany, the consensus that Athens must be treated firmly in order for Greek leaders to implement wrenching but needed economic reforms already appears to be fracturing. Some who have discussed the issue with German officials said Berlin is open to minor adjustments in the programme if a new, credible Greek coalition government is formed after elections next month.

"The whole future of the European Union depends on the actions of this one little country," said Carsten Schneider, Bundestag budget spokesman of the opposition Social Democrats.

As far as Germany was concerned, "the costs of a Greek exit are far too high".

Lisbon tries to avoid being seen as next in line

Portugal is preparing for the possibility of a disorderly Greek exit from the eurozone by reaffirming an unwavering commitment to austerity and a determination to see through economic reforms.

But no matter how hard Lisbon works to differentiate itself from Athens, many investors believe the country would be forced into becoming next in line at the exit if Greece were to leave the single currency bloc.

"Unfortunately, Portugal is the weakest link [among other peripheral eurozone countries]," the Jornal de Negócios business daily said in an editorial yesterday. "However much our leaders explain how our finances are evolving . . . the shockwaves [from a Greek exit] would hit us violently."

Describing the situation in Greece as "a cause for concern", Paulo Portas, foreign minister, compared "political stability, social consensus and a determination to deliver reforms" in Portugal with "permanent crises, a divided society and hesitation" in Greece.

Fitch Ratings said in a report on Monday that Portugal had made a "promising start" towards economic readjustment with its current account deficit shrinking and economic reforms "broadly on track". Exports have also been performing well.

However, many economists believe Portugal will need to supplement the €78bn bailout package it agreed with the EU and the International Monetary Fund a year ago by seeking up to €20bn in additional loans to cover state company debts.

They are also sceptical about Lisbon's ability to resume financing its sovereign debt in the market by September 2013, as envisaged under the adjustment programme.

Portugal's return to the markets faced "substantial risks", the Bank of Portugal said, depending not only on the domestic economy but also on the "evolution of external events".

Pedro Passos Coelho, the prime minister, has insisted Portugal will not ask for more money or more time to pay. But he also points out that the EU and IMF are committed to extending their support for Portugal and Ireland to meet any "circumstances beyond their control".

> €20bn
>
> **Sum that economists believe Lisbon needs on top of its €78bn bailout**

Portugal clearly understands this to mean that it will not be left outside the firewall designed to protect the eurozone from a Greek exit.

Cristina Casalinho, chief economist at Banco BPI, said Lisbon's success in continuing to issue Treasury bills with maturities that have been gradually increased to 18 months was a sign of market confidence.

The fact that a substantial proportion of Portugal's sovereign debt was now in the hands of domestic investors also meant a Greek-style debt restructuring would not bring benefits for Lisbon.

TOMORROW AND ONLINE

Tomorrow: the consequences for business. For previous articles in the series, go to **www.ft.com/ifgreecegoes**

Euro exit will stoke forces of change in east Mediterranean

GLOBAL INSIGHT

Tony Barber in London

Like ships that cross paths in a storm, Greece speeds from the heart of Europe to its farthest shore while a handful of Balkan states steer in the opposite direction.

Greece's departure from the eurozone is not yet a certainty but, across the EU, businesses, bank regulators and bureaucrats are preparing for the possibility.

If it occurred in the next six to 18 months, it would coincide with the EU's admission of Croatia as its 28th member state and the bloc's gradual embrace of Serbia and Montenegro.

Moreover, the political and economic upheaval of a Greek exit might stimulate the wider geopolitical realignment that is unfolding in the eastern Mediterranean. This involves Greece, Turkey, Cyprus, Israel and Russia.

For the EU, these consequences may be just as unsettling as the destabilising influence on western Europe of the eurozone's sovereign debt and bank crisis.

It is hard to exaggerate the national humiliation – not to mention the economic hardship – likely to be felt by ordinary Greeks in the event of a eurozone exit.

After the collapse of its 1967-74 military junta, Greece invested its hopes in shedding its Balkan skin and acquiring a modern European identity.

Up to the outbreak of the national debt emergency in 2009, these hopes were to a certain extent rewarded.

But Greece's progress concealed the pathology of a clientelistic culture in which politicians fed voters with favours and piled mountains of unpayable debts on the state.

Much attention now centres on how Greece might arrange its departure from the eurozone, and the introduction of a new currency, with minimal disruption to banks and businesses.

But such a discussion misses two points. For one thing, it is questionable whether Greece has the administrative capacity to replace the euro speedily.

For another, as Greece's formal eurozone membership melted down, with the European Central Bank cutting credit to Greek banks, euros would be in tremendously high demand among Greek citizens.

The authorities would be under pressure to retain the euro as legal tender, permitting its use in domestic transactions alongside some separate, less valuable unit printed to pay wages and pensions.

In itself, retention of the euro would neither preserve living standards for most Greeks nor help Greece's banks. After taking extensive losses this year on their holdings of Greek sovereign debt, they need tens of billions of euros in recapitalisation.

But if Greece lost its eurozone status, the banks would have no access to the necessary funds. Nationalisation or foreign control would probably follow.

In other respects, however, retention of the euro would give Greece the flavour of daily life in Montenegro and Kosovo, its Balkan neighbours. These two states have used the euro (and, before that, the Deutschmark) since the launch of Europe's monetary union in 1999.

They have no representation on the ECB, which has tolerated rather than encouraged their use of the euro, and so have no say over its interest rate policies. Yet, at least in Montenegro, the euro has proved a success story.

> It is questionable whether Greece has the capacity to replace the euro speedily

The euro has tamed inflation and stabilised the monetary system so effectively that Montenegro began in 2010 to issue euro-denominated debt.

It is a measure of the euro's influence in Montenegrin life that the nation's entry at the Eurovision Song Contest final on May 26 will be a tune called "Euro Neuro".

More serious are the regional implications of a Greek exit from the eurozone. The damage to Cyprus's financial system, heavily exposed to Greek debt, would be devastating.

Cyprus last year received a cheap €2.5bn loan from Russia in a gesture that reflected the Kremlin's interest in protecting wealthy Russian depositors with billions parked in Cypriot banks. It may soon need more aid.

At the same time, the discovery of gas in Cypriot and Israeli waters combined with Turkey's strained relations with Israel to produce closer co-operation among Greece, Cyprus and Israel.

Should their eurozone membership lapse or collapse, it is not difficult to imagine that Greece and Cyprus would be tempted to seek more comfort in the arms of Israel and Russia.

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COMMENT

How Keynes would solve the eurozone crisis

Marcus Miller and Robert Skidelsky

Almost 100 years ago, a young official in the UK Treasury sought to advise European policy makers on how daunting external debts might best be managed. There was, he argued, a limit to the national capacity to service debts. Those expecting further payments were bound to be disappointed. More than that, efforts by creditors to insist on further debt payments would be politically dangerous. "If they do sign," he wrote to a friend, "they can't possibly keep some of the terms, and general disorder and unrest will result everywhere." He recommended a round of debt cancellation among European countries, a plan that would – at the stroke of a pen – remove much of the problem. When he was ignored by creditor governments, John Maynard Keynes quit his post to write the *Economic Consequences of the Peace.*

In today's Europe, of course, the tables are decisively turned. It is not Germany that is suffering under an unsustainable sovereign debt burden, but its southern eurozone partners.

What is the German counsel? Answer: the economics of austerity. Countries with high sovereign debts must increase taxes and cut spending regardless of the consequences for the real economy. Angela Merkel likes to evoke the Swabian housewife: "In the long run you can't live beyond your means."

Underpinning the German position is the belief that resolving debt problems is the sole responsibility of the debtor. Keynes, by contrast, held that both creditors and debtors should share the task of getting economies out of holes they had jointly dug. "The absolutists of contract," he wrote in 1923, "are the real parents of revolution."

The economic effects of this policy are becoming clearer by the day: unlike the US, unlike the Bric countries (Brazil, Russia, India and China), Europe has essentially stopped growing – and there is little hope of growth resuming in the near term. Nor, evidently, have the debt problems been solved. Since the collateral for sovereign debt is citizens' capacity to pay tax, recession and unemployment undermine the capacity to service debts and national credibility in capital markets, as shown again this week by rising yields in southern European debt markets.

The political consequences are, if anything, worse. Talks to form a Greek government have collapsed. This is unsurprising: no government pledged to unalloyed austerity in response to its debt obligations can face its voters with confidence.

For a country in such desperate straits as Greece, an orderly exit from the euro looks to be the best option

Yet Greece is only an extreme example. Centrist governments across the Mediterranean are increasingly seen by their citizens as powerless. They have no independent monetary policy; no capacity to devalue; no right to impose capital controls; limited ability to support failing national enterprises; and now they are mandated to tighten fiscal policy. When moderation fails, the time comes for citizens to turn to those promising to take power into their hands, be they from the right or the left – anything but the pusillanimous centre!

That is what happened in the 1930s. It is a historical irony that European countries that avoided a repeat of the Great Depression after the banking crisis are now driving into the blind cul-de-sac that led to extremism in that earlier disaster. German historical memory has vivid recall of the hyperinflation of 1920-23. But it is possible to forget it was deflation and the Great Depression that brought Hitler to power in 1933.

One of the lessons of history is that sovereign debts must be managed in ways that do not destroy either the economy or the political centre ground. Europe hosts some of the best – and best paid – financial experts in the world; let their talents help governments shake off their paper shackles and devise ways of reducing debt without austerity.

If this means project spending – financed off-balance sheet by jointly-guaranteed liabilities or by higher taxes, so be it. If it means substantial restructuring of sovereign debts swapped into indexed debt or growth bonds, or with grace periods until countries resume growth, so be it. If it requires shifting some of the burden of debt finance on to older generations who own the debt, that political issue must also be faced.

Eurozone countries must be allowed to grow again. For a country in such desperate straits as Greece, however, orderly exit from the euro to regain competitiveness looks to be the best option. But it is in the interest of both Greece and its creditors that the resulting devaluation be controlled. We must not add currency wars to our present pile of problems.

The writers are respectively professor of economics and emeritus professor of political economy at the University of Warwick

American power needs pragmatism

Martin Wolf

davidhumphries.com

What will be the role of the US in the 21st century? This is a question I rashly agreed to address last week at the Carnegie Council in New York. In analysing it, I considered a closely related issue that also exercises Americans: is the future role of the US in its own hands? The answer is: yes, but only up to a point. The US can control what it does. But it cannot control what others do.

The historic dominance of the US is the fruit of its exceptional assets. It is a continental power bounded by oceans to the east and west, and unthreatening neighbours to the north and south. It has huge, albeit dwindling, natural resources. It has had the world's largest economy and the highest output per head since the late 19th century. The market-driven US economy has also been the world's most innovative since at least the same era.

The US is home to the world's most influential financial markets, albeit ones that triggered the Great Depression and Great Recession of recent years. It has been the issuer of the world's main reserve currency since the first world war. It has offered one of the largest import markets, surpassed only by external imports of the EU.

The US possesses the world's most technologically advanced and potent military. Since the second world war, it has also had more of the world's leading universities and research institutions than any other country. It has the world's most potent popular culture. Its political values still grip the world's imagination, even if it has frequently fallen short in practice. Its democratic system has proved sufficiently legitimate and flexible to cope with the many challenges history has thrown up.

Possessed of all these assets, the US managed to form strong alliances and to win its 20th-century wars, both hot and cold, against Germany, Japan and Russia. It shaped the open world economy, which was born after the second world war then became global after the collapse of the Soviet empire. It has offered the world's most influential model of modernity. Whether we like it or not, we all live in the world it has made.

How much of this array of assets will the US retain in this century?

The obvious threat is to its position as the world's largest economy. At market exchange rates, its economy is still roughly twice the size of China's. Yet, according to the International Monetary Fund, it is only 30 per cent larger, at purchasing power parity. Since China's gross domestic product per head, at PPP, is still only 20 per cent of US levels, this leaves huge room for it to catch up. China's growth is likely to slow in coming decades but it should still converge further on US productivity levels. The likelihood is that China will have a bigger economy than the US by the early 2020s. Unlike, say, Japan, China has the numbers on its side. If its GDP per head were to reach half of US levels, its economy would be as big as those of the US and EU together.

China's gross exports of merchandise products already exceed those of the US. Its imports will soon do the same. Being a relatively resource-poor country, China is likely to remain a bigger trader, relative to GDP, than the US. A more controversial question is how soon the renminbi will rival the dollar as a reserve currency. The rise of China's trade suggests the answer is: soon. Against this, I would argue that China's party-state, not being subject to the rule of law and fearing loss of control, will be neither able nor willing to provide the open capital markets that outsiders want if they are to hold their safest assets in renminbi. At least, this shift is likely to take decades, not years.

In principle, the US could also maintain its frontier position in science and commercial innovation. But, as my colleague Edward Luce shows in his thought-provoking new book, the combination of xenophobia with hostility to science, self-inflicted fiscal constraints and weird spending priorities risks robbing the US of its access to the world's talent and its commitment to world-leading research and innovation.* Nothing captures the point better than this grim quote: "In 1990, [California] spent twice as much on its universities as its prisons. Now it spends almost twice as much on prisons." That the US has the highest rate of incarceration in the world is not only a social statistic; it is also an economic one. The same is true of the costliness and inefficiency of the US healthcare system, which is the principal reason why long-term fiscal prospects look so grim.

What is needed is serious reform. But this has become impossible, because of the exploding role of money in politics and the rising intransigence of the Republican party. In a system built on divided government, regarding compromise as weakness risks repeated chaos.

The US economy is also no longer bringing the widely shared benefits it once did. In the last full business cycle, between 2002 and 2007, the top 1 per cent captured almost two-thirds of the rise in incomes, while the top 0.1 per cent captured more than a third. Such a zero sum economy breeds disaffection and despair. The crisis has made the anger far worse.

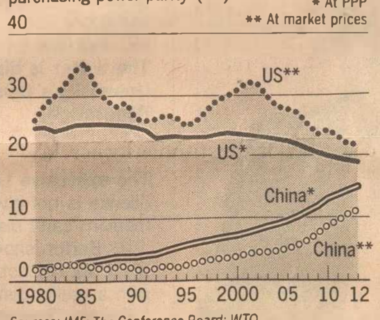
All of this will also affect America's ability to play its historic role in the world. The looming fiscal squeeze will undermine military spending. More important, the financial crisis and other large mistakes have robbed the US political, economic and social models of the prestige they enjoyed. Europe is in no better shape. But that merely means the west as a whole is less credible and so far less able to serve as leader.

Whatever happens inside the US, its influence will be smaller in the 21st century than it was in the 20th. This is largely because others have learnt so much from it. Even so, the US could retain huge, possibly unrivalled, influence, since its main rivals face even bigger challenges. Yet if the US is to be what it can be, it has to rediscover the pragmatism that long marked its policy making, notably in its responses to the many challenges of the 20th century. No democracy can thrive if its citizens view their own government as their greatest enemy. If Americans choose to make their government fail, the US is sure to do so, too.

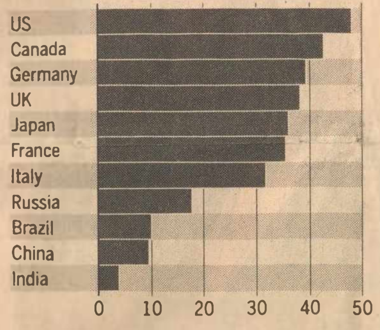
* *Time to Start Thinking, Atlantic Monthly Press 2012.*

martin.wolf@ft.com

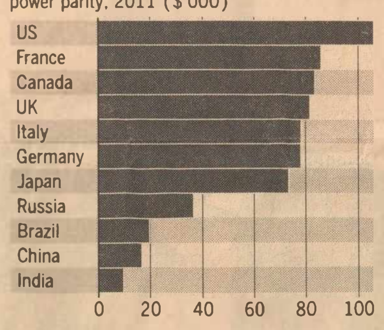
Share of global GDP
At market prices and at purchasing power parity (%)



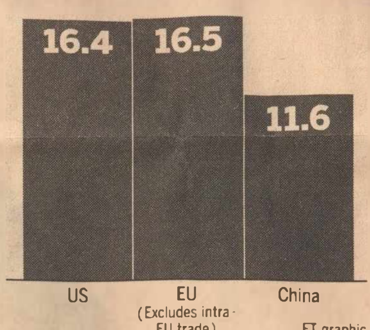
GDP per head
At purchasing power parity, 2011 ($'000)



Output per worker
GDP per person employed, at purchasing power parity, 2011 ($'000)



Share of global trade
% of world merchandise imports, 2010



Sources: IMF; The Conference Board; WTO

FT graphic

The A list

America has its very own resource curse, says **Ian Bremmer**

How Romney could fix the US Senate, by **Bruce Bartlett**

ft.com/alist

The dogma of 'credibility' now endangers stability

John Kay

You will not find the word "credibility" in the *General Theory* of John Maynard Keynes. Nor in Alfred Marshall's *Principles of Economics*, the 19th-century doorstopper that led many economists to say: "It's all in Marshall." And there is just one reference to credibility in Adam Smith's compendious *Wealth of Nations*. Yet Martin Wolf, in his FT column last week, used it 15 times.

How did this term become so central to modern economics? If you continue the word search, you will be led back to a 1979 article by Finn Kydland and Edward Prescott. They start from the premise that the behaviour of companies and households depends on their expectations of the future. If these incorporate all knowable information, and governments lay out consistent fiscal and monetary plans for sustainable public finances and low inflation, the best course for companies and households is to adjust prices and wages to a new equilibrium consistent with prudent budgets and price stability.

The academic argument has had considerable practical influence, as the Swedish committee that awarded Kydland and Prescott the Nobel Prize in economics acknowledged. The case for central bank independence originated in the sensible observation that politicians were inclined to promise more than their economies would deliver, that inflation was a common result, and that a strong central bank governor could help resist this tendency.

Modern economics reframed the issue in the language of credibility: the key to price stability is the credibility of the plan for price stability. Arguments based on faith are impossible to refute: if magic fails, it is because we do not believe enough in magic, if credibility fails to bring about the desired outcome, it is because our commitment is too weak to establish credibility. Since the only markets in which you can immediately see prices adjusting to economic events are securities markets, these markets' movements provide the test of credibility. The resulting power was why James Carville, Bill Clinton's adviser, prayed for resurrection in the more influential role of the bond market.

Even in the bond market, however, expectations are rarely formed with reference to all potentially knowable information: sophisticated market participants base prognostication not on a detailed understanding of future public finances but on conventional wisdom, and on what they have just read in the FT or seen on CNBC. Ordinary people's expectations are derived from Fox News and tabloids. Households may not respond to announcements of future inflation and spending targets by adjusting wage demands and price expectations to market equilibrium. They may instead burn down the central bank or vote the politicians who made these announcements out of office.

Arguments based on faith are impossible to refute: if magic fails, it is because we do not believe enough in magic

The elevation of credibility into a central economic doctrine has turned a sensible point – that policy stability is good for both business and households – into a dogma that endangers stability. The credibility the models describe is impossible in a democracy. Worse, the attempt to achieve it threatens democracy. Pasok, the established party of the Greek left, lost votes to the moderate Democratic Left and more extreme Syriza party because it committed to seeing austerity measures through. Now the Democratic Left cannot commit to that package because it would lose to Syriza if it did. The UK's Liberal Democrats, by making such a deal, have suffered electoral disaster. The more comprehensive the coalition supporting unpalatable policies, the more votes will go to extremists who reject them.

Adam Smith's use of the "c" word was prompted by the inept economic policies of Greece and Rome. The savant noted that in these ancient states, "the employment of artificers and manufacturers was considered as hurtful to the strength and agility of the human body", while restrictive practices and protectionist policies raised the price of manufactures to prohibitive levels. Some classical writers reported prices of manufacture so high that, Smith said, their figures lacked credibility. Perhaps there is continuity after all.

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Iran's leader must choose between enmity and economy

Ray Takeyh

Diplomacy is reclaiming a role in Iran's nuclear drama, but little attention is being paid to a conflict of interests that is likely to complicate Tehran's path to a settlement. The objectives of the western powers are clear: a series of confidence-building measures yielding a durable arms control agreement. Iran's Supreme Leader, however, has to reconcile opposing aims. Ali Khamenei needs America as an enemy and a robust nuclear infrastructure to legitimise his rule. For a long time, he believed he could advance the nuclear programme at a tolerable cost to Iran's economy. Yet now, persisting with convenient enmities will further erode the economy – and could threaten his hold on power. Washington's latest diplomatic gambit depends on whether Ayatollah Khamenei can resolve this dilemma.

As a recalcitrant revolutionary, Ayatollah Khamenei has long pursued a confrontational foreign policy as a means of reinforcing his regime's ideological identity. It is rational for the leaders of the Islamic Republic to adopt self-defeating policies abroad in order to buttress a certain ideological character at home. The theocratic state needs an American enemy and some degree of estrangement from the international community to sanction its grip on power. Enemies lurking abroad, hatching imaginary plots, make it easier for Ayatollah Khamenei to justify his revolutionary verities. Given this need for useful enemies, he must carefully calculate the impact of any agreement with nefarious westerners.

Iran's quest for nuclear capability is also rational, since nuclear empowerment has become a core element of the Islamic Republic's strategic conception. An enhanced nuclear capacity allows Iran to assume a more domineering role in a region beset by unpredictable transitions. Moreover, the history of proliferation suggests that nuclear-armed states receive more favourable treatment from the international community in terms of resumed diplomatic and commercial relations. The argument that a nuclear-armed nation is too dangerous to remain isolated and must be reintegrated into the global system has proved compelling over time. It is therefore no surprise that Ayatollah Khamenei is averse to concessions that would arrest Iran's nuclear trajectory.

Enemies lurking abroad. hatching imaginary plots, make it easier for Khamenei to justify his revolutionary verities

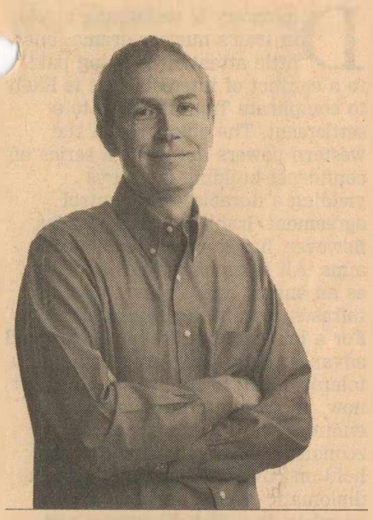
Despite its frequent professions of autonomy and self-sufficiency, Iran depends on global economic structures. It subsists on revenues derived from an export commodity whose price and means of transport are determined by actors beyond its control. For Iran to sell its oil, it requires access to global financial institutions, tankers insured by European companies and customers that have alternative suppliers. Can a state really reject global norms and yet benefit from the prevailing mechanisms of international trade? And here lies Ayatollah Khamenei's dilemma: his revolutionary foreign policy and his quest for nuclear capability are increasingly at odds with the vulnerabilities of his state.

The Supreme Leader today faces a choice he would rather not make. He would far rather persist with his anti-western rhetoric, while incrementally expanding his nuclear apparatus and somehow managing Iran's anaemic economy. Ironically, what may allow him to defer fundamental decisions is protracted diplomacy. A multi-stage diplomatic process suits his inclination to muddle through, as he can trade some modest compromises for some easing of sanctions. In this way he can protect the essential aspects of the nuclear programme while giving his regime some breathing room.

Despite the limitations of the diplomatic process, there is still much the west can do. After decades of sanctions and pressure, the international community is finally placing Ayatollah Khamenei in a position where he can no longer have both his enmities and his economy. The western powers would be wise to stress that sanctions will not be lifted until Iran takes a fundamentally different approach to proliferation. The European boycott of Iranian oil scheduled for July should therefore be implemented irrespective of the offers Iran is sure to dangle between now and then. It is entirely possible that the Supreme Leader will opt to preside over a country with a nuclear programme and a permanently degraded economy. Still, the aim of allied diplomacy should be to force him to make a choice.

The writer is a senior fellow at the Council on Foreign Relations

Capitalism is still the best system there is



Luke Johnson
The entrepreneur

Are capitalists clinical psychopaths? An essay in the New York Times by a literary critic implies they are. William Deresiewicz wrote that capitalism is predicated on bad behaviour, including "accounting fraud, tax evasion, toxic dumping, product safety violations, bid rigging, overfilling, perjury". His premise is that the free market is amoral, and that capitalist values are antithetical to Christian ones.

Such outbursts, like the Occupy movement, and even the recent election of a Socialist president in France, are the products of spoilt societies that are in denial. Widespread ignorance about how material progress is achieved mean academics, politicians and union leaders are whipping up hatred of wealth creators of all kinds.

Do such activists think new products and services appear thanks to government intervention? Where do they think the money to pay for roads, schools, police and hospitals comes from? Do they believe that consumer innovation, technological advance and the funding for taxation emerge from the saintly public sector? Why is the profit motive seen as wicked, while working in places such as universities appears so very ethical?

Perhaps the hatred stems from envy, perhaps from a foolish snobbery towards "trade", perhaps from a pathetic fear of going out and actually selling goods for a living, or perhaps from the common tendency to bite the hand that feeds. I worry that western societies' generous welfare systems have made us so comfortable that too few have to visit factories to discover what commercial production really means, or see what happens when the capitalists leave – the private sector withers and there is no investment or lending. Greece is surely going to find out in the next few years, and the experience is likely to be unpleasant.

Economic affairs are cyclical, but this generation is so prosperous that it finds the prospect of a long recession almost too much to bear. We are all used to having a safe job, our own home or housing-support, foreign holidays and all the rest. All this munificence is only possible because free enterprise incentivises entrepreneurs to build companies. From those undertakings flow work, exports, tax and the other elements which form modern civilisation. Disown all that, and the edifice crumbles. This appears to be what Greece is doing – embarking on a course of national suicide, thanks to a gargantuan sense of entitlement and dependency.

The usual cures to the "evil" of capitalism are put forward in the NYT article: more legislation, regulation and taxation. Yet those countries that are creating most jobs and seeing rising living standards – such as Brazil, Turkey and China – exact far fewer tolls on companies than we do in the west. The brilliant anti-business intellectuals would solve our problems of unemployment, debt and stagnant wages by doing the opposite of the policies adopted by the world's most buoyant economies. Meanwhile, leftwing economists suggest that the cure for government deficits is even more debt.

> **"Damning an entire class for the high-profile errors of the few is ill-judged"**

That these assertions have found traction with electorates is depressing. Possibly, capitalism is poor at promoting the cause and explaining its merits. We need to counter myths propagated by the left that "shafting your workers, hurting your customers, destroying the land" is how the system works. If it were, every company would go broke.

No doubt most highly successful entrepreneurs are tough individuals. Some break the rules, but damning an entire class for the high-profile errors of the few is destructive and ill-judged. And this is the age of the whistleblower – if they were all crooks, surely they would get caught.

Moreover I suspect top professors, doctors, editors, architects, scientists and those at the summit of every profession are just as competitive and egotistical as leaders in the worlds of commerce and finance. I'll bet that ruthless ambition – for fame, power and even money – is just as common in labs, lecture theatres and surgeries as the boardroom.

I suppose everyone facing hard times wants scapegoats for their present difficulties. Capitalism, bankers, entrepreneurs and the like all seem like suitable targets for blame. But if we abandon capitalism for collective ownership and central planning, we really will be acting like psychopaths.

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The writer runs Risk Capital Partners, a private equity firm, and is chairman of the Royal Society of Arts

Judgment call

Is offence the best form of defence in a reputation crisis?

The problem

Last weekend, football player and Twitter user Joey Barton used the social media to attack critics of his behaviour in the final match of the Premier League season. By contrast, when Scott Thompson, ex-CEO of Yahoo was at the centre of a controversy over his credentials, he stayed out of the limelight. Which is the best form of defence when you are in the middle of a storm?

The advice

The executive Jon Moulton

There are three possible responses.

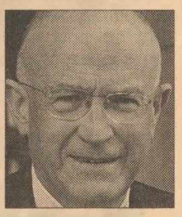
Ignore the issue. You may be lucky if it comes at a time when there are bigger news stories. The media have little persistence and will move on. This is always the preferred strategy.

Respond if serious damage is being done. But mounting a defence is difficult because the media prefer "knocking copy" to dull fact – and this makes a defence less likely to get covered.

So, it is usually best to ignore your PR man's advice – the only certainty is that defence generates more PR fees than passive suffering. You can counter attack but this is only likely to work if the counter attack is much stronger than the scandal itself. This is rarely a productive route.

Finally whatever you do, don't lie. You will probably be found out.

The writer is chairman of Better Capital, the private equity firm



'Whatever you do, don't lie. You will probably be found out'

The academic Rupert Younger

Staying silent mid-controversy is not an option. If you don't engage, others will. The issue is what to say in a controversy, and how to say it.

The most important thing for any individual is to do the right thing: apologise publicly for actions that were unacceptable in the first place. Neither Mr Barton nor Mr Thompson has come out well – but this is less to do with whether to engage or not and more about what they chose to say and how.

The writer is director of Oxford University's Centre for Corporate Reputation

'Staying silent mid-controversy is not an option'

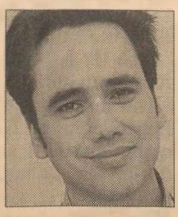
The executive Lawrence Merritt

Silence is not always golden. But the medium can't distort reality either.

Mr Barton should have remained silent and/or not confused Twitter with a reality distortion device.

For Mr Thompson, silence was not golden. This man was chief executive of a company in the business of communication, but his lack of new-media savvy to battle his detractors damaged him as much as the CV debacle itself.

The writer is managing director of Photobox



'Silence is not always golden'

The PR consultant Chris Salt

Silence can be the best way to navigate difficult issues of reputation management, but more often than not offence is the best defence.

The pre-social media posterchild for dealing with such situations is Hugh Grant. In 1995, the actor was caught "in a moment of madness" with a prostitute on Sunset Boulevard. Instead of hiding, he went on *The Tonight Show with Jay Leno* and conducted a huge mea culpa. In doing so he recovered his reputation.

So, move fast and manage your message before others do it for you.

The writer is chief executive of HeadLand Consultancy

'More often than not, offence is the best defence'

Going for sportswear gold

Entrepreneurship

Australian sportswear business 2XU has grown by building a reputation with serious athletes, writess Neil Hume

Aidan Clarke is itching to reveal 2XU's most extraordinary endorsement. But the 40-year-old co-founder of the Australian sportswear company can't. It's "classified information", he jokes.

"You can certainly say US military operatives are wearing 2XU, including the Navy Seals and the Army Rangers, but we've been warned against referring to any specific tactical groups," he says.

It is an issue the company, which aims to be a global sportswear brand, has faced many times since it was founded in the Melbourne suburb of Hawthorn in 2005.

"Turn to page 53 and see what he's wearing," urges Mr Clarke, pushing the April edition of ESPN The Magazine across the table. The "he" is LeBron James, the basketball star whose legs are clad in a pair of 2XU-branded compression tights, which retail for as much as A$185 ($185). "He's got a multimillion-dollar Nike contract and look what's he's got on," continues Mr Clarke, who claims there are many other elite athletes wearing 2XU's range of performance-enhancing tights, shorts, tri-suits and calf-guards. 2XU – Two Times You – denotes "multiply your performance", he explains.

Mr Clarke can reel off a long list of NBA and American football teams that have bought 2XU branded garments for players to wear under their uniforms, including the Los Angeles Clippers, the New York Knicks, Oklahoma City Thunder, the New York Jets and New York Giants.

Such deals along with alliances with sporting bodies such as Swimming Australia and the PGA of Australia have helped 2XU increase sales at an annual compound rate of 40 per cent over the past four years and carve a profitable niche in sportswear. The company was recently valued at more than A$100m in a round of private equity funding and expects profits of A$10m on sales of A$40m in the year to July 2012.

Clyde Davenport founded 2XU in 2005. The 57-year-old former advertising executive had just sold his eponymously named upmarket underwear business for A$15m and says he had no desire to get back into apparel. But then he met Mr Clarke and Jamie Hunt, a 40-year-old former professional triathlete, who had been working for Orca, a New Zealand company that makes wetsuits for triathletes. They wanted to start their own high-performance sportswear business. "I saw in them the person I was 17 years earlier," says Mr Davenport. So he threw his lot in with the two Kiwis, providing years of expertise and several million dollars in seed funding.

The initial strategy was to position 2XU as a "technical performance" brand focused on triathlon. The founders thought this was a market they could dominate relatively quickly because it had been ignored by the big brands. They would then use it as a platform to push into other categories such as running and cycling.

But that changed as Mr Davenport became interested in compression sportswear, which proponents claim helps reduce muscle damage and speeds up recovery after strenuous exercise by stimulating blood flow. At that time, only one other Australian business called Skins was focused on compression and Mr Davenport thought he could do a better job. "We had the knowledge and ability to develop a far superior product and . . . We all knew, especially Jamie, the importance of improving performance and recovery for elite athletes."

An early big break for 2XU came when Triathalon Australia, the sport's governing body, asked it to provide suits for the 2005 World Championships in Gamagori, Japan. "The elite coaches at the time had been let down. But they knew Jamie and Aidan could make a tri-suit because of their time at Orca," says Mr Davenport. The Australian team went on to dominate the championships, taking gold medals in the main men's and women's events, which opened doors with buyers as Mr Clarke hit the road with the first collection. "Our kit was on the front page of every tri magazine," he says.

Slam dunk: 2XU was started by Jamie Hunt (left), Clyde Davenport and former professional triathlete Aidan Clarke and has expanded its global presence by building links with sports stars such as US basketball player LeBron James (below)
Ruth Perry

He hopes for similar success at the London 2012 paralympics, where 2XU is providing the Australian team's kit.

What has really helped create a buzz around the brand has been the relationship between 2XU and the Australian Institute of Sport, the government-backed national training body, that dates back to 2005. 2XU now funds research in the AIS's recovery division whose sole aim is to test the designs and fabrics that Mr Hunt, director of product development and company's technical brains, sources from mills in Europe and Asia. He explains that most of the clothes are made in China, not because it is cheaper but because the factories have the best sewing and cutting machines.

This relationship also means the company is able to back up its "performing enhancing" claims with quantitative data which is a big selling point. The founders cite one test the AIS carried out on a dozen top cyclists. "The guys that were not wearing 2XU during the recovery had an almost 2 per cent drop-off in aerobic capacity. But those who wore 2XU came back within 0.1 per cent of their aerobic capacity, and with a lower heart rate," says Mr Clarke. In professional sports, even such small margins can make the difference between first and fourth.

The challenge now is to take the business from "the locker room to the mass market" without the marketing firepower of a Nike or Adidas, and without damaging the brand. In order to hit its A$100m short-term revenue target, Mr Davenport says they will have to explain to weekend golfers why they need an A$50 pair of compression socks and to convince women that its A$110 high-impact sports bra is really worth the money. "The biggest issue we have now is explaining what our product can do. Otherwise it is just a very expensive top, sock or bra," he says. To that end, 2XU sold a "significant minority equity" stake to the Australian private equity arm of investment bank Lazard last November, which allowed the company to acquire its US distributor and start work on two flagship performance centres – what it terms "experiential retail" – on the west coast.

But if it is to fulfil its ambitions to become a company with A$1bn of sales, it will need to add more distributors – 2XU is in 40 countries so far – and expand ranges, as well developing e-commerce and social media. Mr Clarke is optimistic. "If you look at some of the start-ups that have got to A$1bn of sales in the past 10 years, Lululemon [the yoga clothing label] for example, we are tracking them."

2XU's Dos and Don'ts

Do:

Have a scalable unique, creative idea.

Choose a market position where you can realistically become an industry leader, and find your unique selling proposition.

Spend within your means. So many start-ups think profit is for the distant future. Business doesn't last long if you are just practising, so get a hold of the profit-and-loss account early and spend within your budgets and cash flow – and know your capital requirements.

Remember that if it was easy everyone would be doing it, so push through the barriers and naysayers.

Don't:

Produce a product exactly like everyone else – marketing differentiation is difficult and you become commoditised to price point.

Forget your brand personality and what you stand for – ensure you deliver it consistently and make sure the experience matches the brand promises.

The business traveller

Working during a flight

WiFi and now mobile phones have started making their presence felt on flights. Can the cabin be an extension of your office?

Is it wise to work mid-air?
Working solid for a seven-hour flight will not leave you at your best when you arrive. However, Julie Hurst of the Work Life Balance Centre says: "If you work in bursts with some downtime in between to allow your brain to get back up to full speed, why not? Working with regular stops means you can sustain high levels of effort for a long period."

How do I plan my time?
The biggest restriction is that mobile-phone calls are not allowed while you are flying over the US or within 250 miles of US airspace, so schedule accordingly. The limited number of mobile lines means you may not be able to speak when you want to. Expect WiFi to feel slow.

Is it secure?
Take the same precautions as when using WiFi in a hotel and use a VPN if you have one. Privacy on airlines can be minimal and the risk of sensitive documents being visible to prying eyes is high.

Who offers what?
Many airlines offer some form of in-flight connectivity. Among them, BA's OnAir service lets passengers use phones for text and internet on its Club World London City Flight, a business-only flight to New York; Emirates offers WiFi and calls; Virgin says calls will be possible on transatlantic routes on 13 aircraft by the end of 2012. Many US airlines offer WiFi.

Rhymer Rigby

18

Gene Frieda
INSIGHT

Lack of good collateral is Achilles heel of euro rescue

It has been little more than two months since the European Central Bank conducted the second of two three-year longer-term refinancing operations. After veering dangerously close to the edge of another financial cliff, markets were jerked back to safety by the ECB's actions. Given the scale of these measures – injecting around €1tn into the eurozone banking system – it is striking how short the respite has been, and pressure is again building. Where are we going? Head-on into a policy dilemma borne out of fear and complacency.

Fear is a powerful incentive to wait and hope. Outside the smaller peripheral economies of Greece, Ireland and Portugal, neither eurozone creditor governments nor indeed the International Monetary Fund wants to open the Pandora's box of loans to the larger periphery economies of Spain and Italy. To do so would expose the folly of a tiny eurozone firewall and the unfathomable possibility that sovereignty is transferred from two of the bloc's largest economies to Brussels.

So it is better to hope against all hope that the Spanish will fix Spain and the Italians will fix Italy, rather than to formalise realistic contingency plans for minimising the cost of de facto currency crises in these economies.

Neither creditor governments nor the IMF wants to open the Pandora's box of loans to the larger periphery economies

Complacency stems from a belief, thus far confirmed by events, that the ECB will act as a lender of last resort to sovereigns, at least indirectly via the banks. Investors and policy makers alike assume the ECB will simply repeat its late 2011 actions.

The key point is that the eurozone's current firewall relies, at its core, on collateralised lending to stressed periphery banks. The lack of good collateral is the Achilles' heel of this rescue strategy. As periphery banks' balance sheets shrink, so, naturally, do the asset bases with which they can borrow from anyone on a securitised basis. These banks will be inclined to run out of eligible collateral again and again as they are forced to finance foreigners exiting the periphery.

Accordingly, another huge liquidity injection will only be possible if the ECB accepts ever-riskier collateral or assumes smaller haircuts on its existing collateral. But there is evidence, from the commentary of several national central bank governors since the LTROs, that they are extremely averse to doing so. Their comments echo those of their respective governments, underscoring that risk-sharing through the back door is becoming just as difficult as debt mutualisation, in the form of common eurobonds, through the front door.

Last year, ECB president Mario Draghi had to wait until banks were at the precipice of collapse in order to garner a consensus for action among the hotchpotch of hawks and doves that make up the ECB's governing council. At that point, there was little question, legal or practical, about the prudence of his actions. This time there is.

A dwindling pool of 'good' bank collateral raises doubts about how long the eurozone's crisis response can muddle along

Hence the dilemma. The ECB has thus far acted like a prudent central bank. While acting liberally in agreeing to accept riskier collateral, it chose to require national central banks to hold the riskiest securities on their balance sheets.

Now, any losses on the new, riskier collateral will be borne solely by the NCB that oversees the borrowing private bank. These NCBs are thus incentivised to pick carefully what types of collateral they accept. The central banks have imposed haircuts averaging 53 per cent on the new collateral, implying that for every €100 of collateral posted by the banks, they receive only €47 of cash liquidity. In this respect, Mr Draghi is fully justified in stating that the ECB has acted to insulate itself from the unprecedented balance sheet risk it is taking.

But safe lending practices mean less relief for the banks. And in the present context, high haircuts mean less collateral available for refinancing purposes in moments of extreme need. If a bank loses €1 of private funding, whether through deposit flight or the loss of access to private wholesale markets, it still needs to fund €1 of new funding.

A dwindling pool of "good" bank collateral raises doubts about how long the eurozone's crisis response can muddle along. Private lenders, cognisant that a competing loan by the official sector – collateralised or not – subordinates their own interests, either seek as much of the best collateral as they can find, or simply stop lending.

The ECB can, as before, save the day by taking ever larger default risk on to its balance sheet, but it cannot have its cake and eat it. The crisis narrative involves ever more collateral transfer from periphery to core and ever more subordination of private sector interest to the official sector. It may allow a muddled middle way between default and debt mutualisation to go on, but there is no clear exit strategy. At best, the ECB's actions have succeeded in making the crisis more chronic than acute, with private investors waiting for the next LTRO to get out.

Gene Frieda is a global strategist for Moore Europe Capital Management

Greece to repay €435m bond in full

Attempts at a deal with investors fail

Move comes despite threat of default

By Kerin Hope in Athens and Richard Milne in London

Greece is to repay fully a €435m bond that matured yesterday after failing to reach a deal with holdout investors, including private banks and a US-based hedge fund.

The move marks a significant twist in the restructuring of Greece's debts after Athens had warned earlier this year that it would default on any bondholders who refused to take part in its €206bn bond swap.

It is likely to provoke anger from the 96 per cent of bondholders that took part in the restructuring, which includes Greek pension funds and other investors, all of whom suffered losses of about 75 per cent. The holdouts in the bond, issued under English law, are believed to include several hedge funds.

"Never mind what we think. Just think how angry the Greek investors are going to be. They said all along they wouldn't pay these evil hedge funds and now they are," said one banker involved in the restructuring.

A statement from the Greek finance ministry said the decision did not necessarily mean it would pay out on all the €6.4bn in foreign law bonds that were not part of the restructuring.

"The decision weighed carefully all relevant factors and implications as well as the current conjuncture. Today's decision does not prejudice future decisions on the treatment of the remaining bonds not tendered in the PSI exchange," the ministry said.

Officials in Athens said it was important to repay the bond amid Greece's political turmoil and doubts about it staying in the single currency.

"It was considered imprudent to default on a bond issue at a moment of political instability, when the country's membership of the euro is being questioned," one official involved in the transaction said.

Greece has enough funds to cover the repayment after receiving a €4.2bn transfer last week under its second bailout agreement with international lenders, a senior banker said.

"It was a sensible decision to pay up . . . In this environment you don't want another negative shock," the banker said.

Greece's European partners were expected to back the decision to make a full repayment given the exceptional circumstances of the redemption falling due as Greece scrambled and failed to put together a coalition government after an inconclusive election on May 6, the government official said.

One investor in the bond said there had clearly been uncertainty about how to proceed right until the last minute.

"They were paralysed and could not decide," the investor said. "So behind the scenes they had the [European Central Bank] and the [European Financial Stability Facility] make the decision for them."

The repayment would be made out of funds allocated under the second bailout for paying off holdout investors in exceptional cases. But the funds available would only cover a small percentage of the remaining €6bn of foreign-law bonds held by private investors.

Additional reporting by Patrick Jenkins

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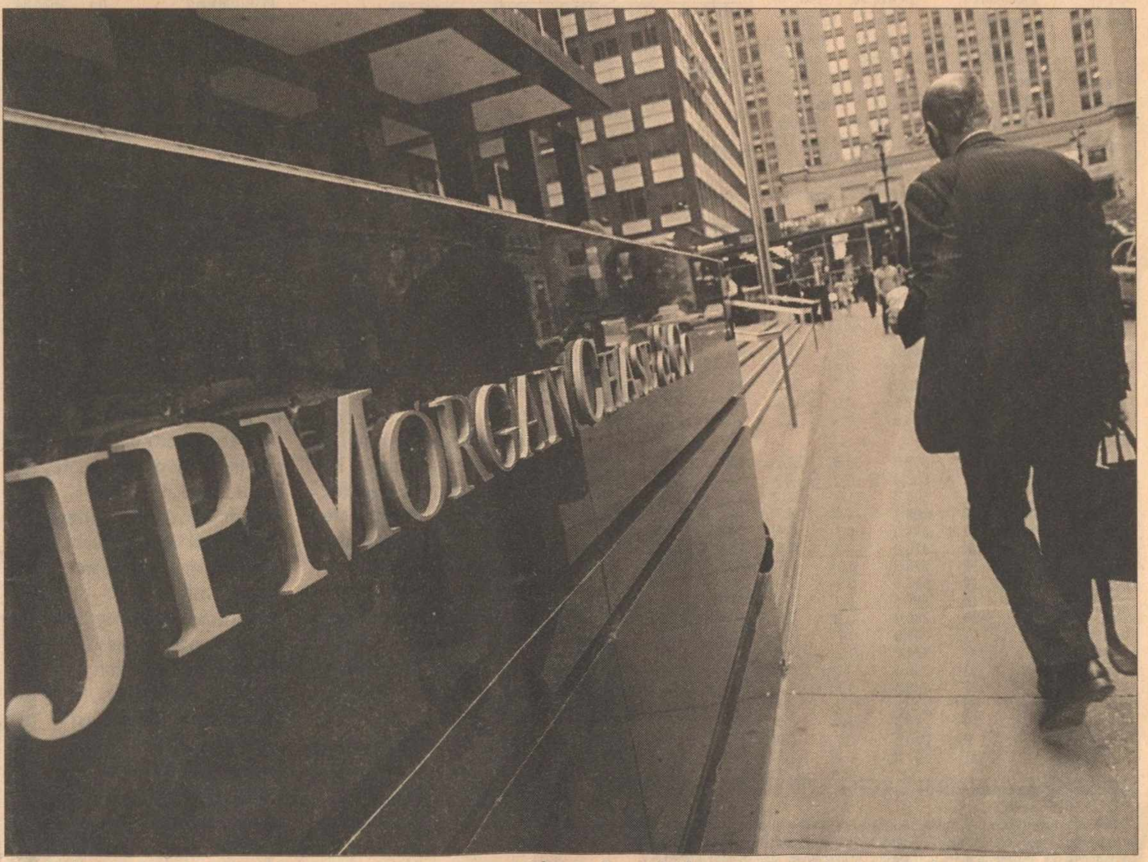
JPMorgan loss exposes dangers of derivatives

News analysis

There are fears new rules could raise financing costs, write **Michael Mackenzie, Nicole Bullock** and **Telis Demos**



Big dealers dislike the idea of trading derivatives on an exchange-type platform as it could reduce their profit margins AP

Credit derivatives were the brainchild of savvy bankers at JPMorgan in the 1990s. Now the bank and one of Wall Street's most controversial products are under intense scrutiny.

As JPMorgan reels from a complicated hedging strategy – one that misfired to at least $2.3bn in losses – derivatives market participants worried about new rules on trading fear it will be harder to argue for more lenient treatment.

The loss is also a reminder of the dangers of seeking bigger profits by minimising the cost of hedging. While credit derivatives were created to allow lenders to offset the threat of a default by a borrower, the product has been associated with a number of blow-ups in recent years.

These include the effect on Wall Street trading books in 2005 when US carmakers lost their investment grade rating status. Then came AIG's huge losses from writing credit insurance on mortgage bonds to big banks in 2008, which led to a bailout from the Federal Reserve.

Deutsche Bank lost more than $1bn from credit derivative trading as the financial crisis intensified.

"It is an indictment of risk management," says Ed Grebeck, chief executive of Tempus Advisors, a global debt management strategy group. "What has happened in the last several years is that every time everybody says everything is okay, another one of these situations happens. And there are more coming."

While details of JPMorgan's strategy are unclear, traders say the bank created a large portfolio of swaps over underlying holdings of bonds that involved selling protection on one credit index, the so-called CDX North American Investment Grade index series 9, while purchasing insurance on other contracts. Income from writing insurance on one index helps pay for buying insurance on other indices.

Such positioning reflects how much of Wall Street's hedging activity is based on assumptions on changes in the relationship between different indices and their constituents. It relies heavily on models that look to economise the costs of hedging. "All financial institutions are only profitable if they take risk, if you hedge away all risk, there is no return," says Andrew Lo, professor at MIT.

Trading in the credit default swaps market is conducted on a bilateral basis between two counterparties. This means the market still operates in the dark, with trades privately negotiated between two parties. Banks and investors that amass large positions can become vulnerable to a so-called "squeeze".

That is the situation JPMorgan found itself in as hedge funds sensed strains in the management of its positions and traded aggressively against the bank.

"Trading in size in a bilaterally negotiated world can put you in the worst position you can be in: the trade going against you and the Street knows," says Christian Martin, a former swaps trader at Merrill Lynch and co-founder of TeraExchange, an electronic CDS platform.

Big dealers dislike the idea of trading derivatives on an exchange-type platform, as it stands to reduce their profit margins substantially. But a public record of deals would mean a more transparent market less prone to dominance by a single participant.

While JPMorgan's losses to date are a fraction of its balance sheet and it is believed the trades were centrally cleared, satisfying one key area of derivatives reform, there is, nevertheless, much at stake for the industry and swaps trading.

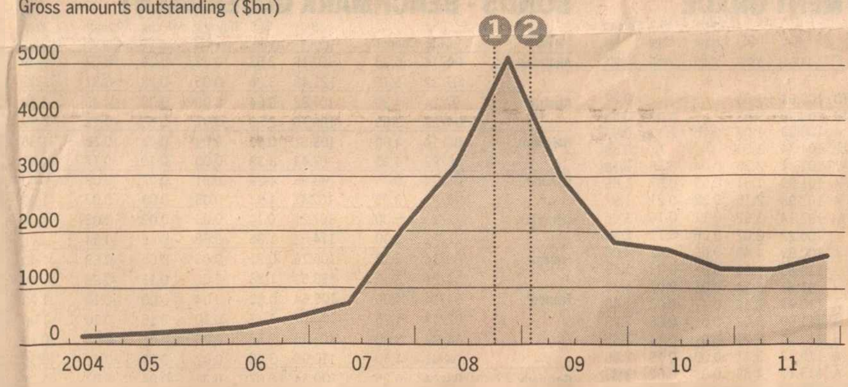
Wall Street has resisted efforts to reform the trading of derivatives since the signing of the Dodd Frank Act in 2010. The industry has warned tough rules for derivatives trading could harm liquidity and impair the ability of banks to hedge loan and bond risk, ultimately raising the cost of financing for companies.

In the past year, moreover, outstanding CDS trades have fallen a fifth as the market has cut risk and banks deal with the prospect of higher capital charges.

The index in which JPMorgan is believed to have had a large position initially rose on the news of its losing position, an indication the losses could be higher than the bank reported (the bank is thought to have moved to neutralise its positions). Therein lies a wider risk.

"JPM is a major player in credit derivatives and by no means the worst managed," says Satyajit Das, a derivatives trader turned consultant. "If it curtails its activities then the loss of liquidity may affect other players and result in unrelated losses."

Credit default swaps
Gross amounts outstanding ($bn)



Source: BIS

1. In September 2008, AIG, the insurer, faced some $30bn in losses in credit default swaps on complex mortgage securities sold to banks such as Goldman Sachs
2. In February 2009, Deutsche Bank reported a fourth-quarter €1bn loss in prop trading on credit, as bets on relative values of corporate bonds began turning against it

In May 2012, JPMorgan reported that a series of hedges of credit exposure had lost $2bn

Backlash brews over longer trading day for grain futures

COMMODITIES

By Gregory Meyer in New York

Exchanges face a growing furore over a longer trading day in grain futures as traders fear it will lead to knee-jerk reactions to sensitive crop reports.

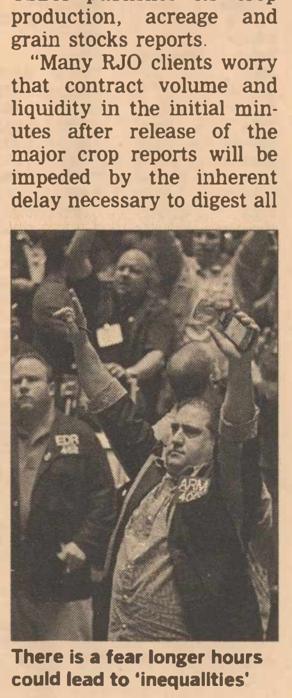
The backlash puts CME Group, the biggest US futures exchange operator, in a delicate position as it fends off new competition in agriculture and balances the needs of farmers and grain handlers with electronic traders.

The Chicago Board of Trade, a CME exchange, next week plans to allow electronic trading of crop futures, including corn, soyabeans and wheat for 22 hours a day, extending sessions by five hours. The move comes after rival IntercontinentalExchange this week launched lookalike contracts, challenging Chicago's dominance in the grain pits.

The new hours overlap with the release of crop reports that regularly move markets. Until now, the US Department of Agriculture's reports were released while trading was halted.

RJ O'Brien, a big Chicago-based futures broker, yesterday implored exchanges and regulators to freeze trading on the 15 days each year when the USDA publishes its crop production, acreage and grain stocks reports.

"Many RJO clients worry that contract volume and liquidity in the initial minutes after release of the major crop reports will be impeded by the inherent delay necessary to digest all of the updates," said Gerald Corcoran, chief executive.



There is a fear longer hours could lead to 'inequalities'

Last week grain handling groups, including the National Grain and Feed Association, said longer hours "could lead to competitive inequalities and impose significant additional costs" in personnel and technology.

Grain is one of the few markets where trading halts around important data releases. Oil futures stay open when weekly US petroleum supply numbers appear.

Smaller agricultural markets, such as Liffe milling wheat in Paris and ICE canola oil in Canada, already trade during USDA releases and to a degree are proxies for other commodities during the Chicago hiatus.

Hubert Hamer, chairman of the USDA's Agricultural Statistics Board, said the agency was discussing the longer sessions. "Any change to the report release schedule is complex, has far-reaching impact, and would be taken very deliberatively," he said.

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UK crackdown imposes new rules on order flow payments

By Brooke Masters, Chief Regulation Correspondent

The UK Financial Services Authority has cracked down on the contentious practice of market makers who pay for order flow, imposing new conflict of interest rules and disclosure requirements on brokers that take the fees.

The watchdog waded into the area last year after receiving complaints from investors concerned that the payments were improperly influencing where their orders were routed. Brokers in the UK have a legal duty to get "best execution" for customer orders.

"We believe [payment for order flow] PFOF arrangements create a clear conflict of interest between the clients of the firm and the firm itself," the FSA wrote in guidance issued this week.

The watchdog said it was concerned that brokers would shut out market makers who do not offer such inducements and that market makers were incorporating the cost of the payments into the spreads they offer. Payments by market makers are often larger than commission paid by clients, brokers said, yielding some brokers many thousands of pounds a year.

"This practice may interfere with the broker's duty to act in their clients' best interests, for example by directing the order to the market maker who pays the most," said Paul Richards, a member of the FSA's wholesale conduct policy team. "The finalised guidance makes clear that such payments can only be made where they comply with our rules."

But the watchdog stopped short of banning the payments. Instead, it required firms to tell customers about them and put procedures in place to make sure the payments led to better – not worse – service.

"Firms who continue to operate PFOF arrangements will need to commit additional resources to managing conflicts of interest and ensuring best execution for their clients. Practically, it remains to be seen how firms meet this challenge," said Tony Katz, law partner at Orrick.

'This practice may interfere with the broker's duty to act in their clients' best interests'

The practice of paying for order flow was pioneered by Bernard Madoff, who later went to prison for running a huge Ponzi scheme, and it has been subject to strict disclosure rules in the US for years. The practice is becoming more common among UK retail brokers.

The FSA guidance was virtually unchanged from the consultation it put forward last year, despite strong opposition from broker groups such as the Futures and Options Association and the Association for Financial Markets in Europe. Brokers said the payments reflected services provided to the market makers, such as market intelligence, and did not interfere with best execution duties.

Additional reporting by Philip Stafford