FINANCIAL TIMES

June 18, 2012 7:26 pm

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Euro’s Greek honeymoon short -lived

By Robin Wigglesworth in London, Chris Giles in Los Cabos, Mexico and Kerin Hope in Athens

The election victory for pro-austerity parties in Greece failed to assuage fears over the eurozone’s future, as investors ratcheted up the pressure on policymakers by sending Spain’s benchmark borrowing costs to a new euro-era high.

Markets initially rallied on news that New Democracy and Pasok, two mainstream parties that support the austerity conditions of the eurozone’s bailout, gained enough seats to form a parliamentary majority in Athens. But the optimism was swiftly deflated by dismal bad bank loan figures in Spain that underlined the country’s woes.

Data from the Bank of Spain showed that the non-performing loan ratio of Spanish banks rose to 8.7 per cent of their outstanding portfolios in April – the highest in almost two decades.

The eurozone has already promised €100bn to help recapitalise Spain’s banks, but investors are concerned it could merely increase Madrid’s debt burden and eventually lead to a full sovereign rescue.

Spain’s benchmark 10-year bond yields, which move inversely to prices, climbed as high as 7.28 per cent on Monday, while the euro retreated sharply against most other major currencies. Italy’s 10-year bond yields rose above the 6 per cent mark again.

“The Greek election merely postpones a consideration of the underlying problems,” said Sushil Wadhwani, a hedge fund manager and former member of the Bank of England’s monetary policy committee. “The markets are tiring of things that buy a little time and do not deal with the underlying, fundamental issues.”

Speaking at the start of the G20 summit in Mexico, José Manuel Barroso, the president of the European Commission, indicated that the terms of Spain’s banking rescue were still up for negotiation and acknowledged market fears that the continent’s banking and fiscal crises are becoming increasingly intertwined: “We have been in favour, as far as possible, in avoiding any kind of contamination of financial debt and sovereign debt.”

While the Commission and many eurozone countries have been in favour of using the continent's rescue fund, the European Stability Mechanism, to inject equity directly into failing eurozone banks, Germany remains opposed and has a blocking vote on the ESM board.

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Investors have begun to focus their concerns on a eurozone summit scheduled for the end of the month, with many hoping that European policymakers will make progress towards some form of fiscal union to prevent the common currency bloc from unravelling. The first step will be approval of the "fiscal compact" agreed by 25 out of the European Union's 27 members in January. Even Germany, however, has yet to ratify the legislation.

Some strategists and investors predict that the European Central Bank could be forced to intervene before the eurozone summit to prevent Spain and Italy's borrowing costs from spiralling higher in the short run.

"The ECB may well have to act as soon as this week," said John Wraith, a strategist at Bank of America Merrill Lynch. "It's shocking how quickly the recent rallies have unravelled. The market is not giving policymakers any breathing space any more."

Nick Gartside, international chief investment officer for JPMorgan Asset Management, argued that central bank action would only be a short term palliative for the eurozone's challenges.

"We need a clear roadmap towards more fiscal integration," he said. "The big bazooka is on the fiscal side, not the monetary side."

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