FINANCIAL TIMES

June 12, 2012 7:55 pm

Fears rise over EU handling of debt crisis

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By FT Reporters

Spain's borrowing costs hit a euro-era high on Tuesday amid sagging investor confidence that Europe can prevent its debt crisis from worsening and wrangling among policy makers over how to implement cross-border banking supervision.

The yield on Spanish benchmark 10-year debt hit 6.8 per cent just days after eurozone finance ministers agreed a €100bn bailout package for the country's banks. The move was accompanied by rising bond yields in countries deemed less risky, such as Germany and the UK, where market interest rates have been at record lows.

"The crisis is deteriorating at an ever-increasing pace," said Mark Schofield, a senior strategist at Citigroup. "Investors are increasingly pricing in either of the two tail risks – full eurozone break-up or fiscal union."

Officials have insisted the EU has sufficient short-term mechanisms to deal with the crisis in the form of its rescue funds, while the debate over longer-term measures has shifted towards greater fiscal co-ordination and Europe-wide banking supervision.

Angela Merkel, German chancellor, spoke out in support of European banking regulation, although she stopped short of backing a region-wide resolution scheme, which Berlin fears could burden the country with joint liability for other's debts.

"Germany – and I can say this for the whole country – is prepared to do more on integration but we cannot get involved in things which I am convinced will lead to an even bigger disaster than the situation we are in today," she said.

In London, George Osborne, Britain's chancellor of the exchequer, questioned whether a Greek exit from the eurozone was a price that had to be paid to persuade Germany to save the single currency.

"I just don't know whether the German government requires Greek exit to explain to their public why they need to do certain things like a banking union, eurobonds and things in common with that," he said at a business event organised by the Times newspaper.

Vítor Constâncio, vice-president of the European Central Bank, weighed into the debate over a proposed banking union, arguing that the ECB should take charge of supervising the eurozone's top banks.

The comments underscored ECB policy makers' determination to drive forward a banking union – in spite of scepticism by Germany's Bundesbank and the risk of damaging turf wars with other EU institutions.

Since its launch in 1998, the ECB's main task has been controlling inflation. But speaking in Frankfurt, Mr Constâncio said EU treaties already included provisions for giving it supervisory responsibilities. Out of the 17 eurozone national central banks, 14 already had responsibilities for overseeing banks, he said. "Institutional build-up would not be necessary."

Supervisory powers for the ECB have also been backed by Christian Noyer, France's central bank governor. Britain – not in the eurozone – also favours using the ECB to oversee a banking union.

However, the ECB vice-president confirmed there was no formal ECB position yet. German policy makers fear that expanding the ECB's tasks could weaken its control over inflation and just hours earlier, Andreas Dombret, a Bundesbank executive, had said proposals for a banking union "appear to be premature".

Separately, Sabine Lautenschläger, the Bundesbank vice-president, told a Frankfurt conference that a banking union had to be preceded by fiscal union.

A banking union should become "an integral counterpart" of monetary union, the ECB argued in its financial stability review, published on Tuesday, which identified a "potential aggravation" of sovereign debt crisis as a "key risk" to the block's financial stability that could plunge it into deep recession.

The ECB saw EU banks shrinking balance sheets by €1.5tn, mainly via asset sales, by the end of 2013 – although that was less than estimated by the International Monetary Fund. The report did not consider the risks of a possible Greek exit from the eurozone, which Mr Constâncio said would be "virtually impossible to assess".

Reporting by Ralph Atkins and James Wilson in Frankfurt and Robin Wigglesworth and George Parker in London

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