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Taxpayers in Spain left holding bag after bailout

MADRID

Realization that country is ultimately responsible for losses rattles investors

BY RAPHAEL MINDER

After clinching Spain's €100 billion bank bailout, Prime Minister Mariano Rajoy flew to Poland on Sunday for the Spanish team's soccer match, declaring "this matter is now resolved."

Not so fast, prime minister.

On Tuesday, Spain's long-term borrowing costs soared to their highest

NEWS ANALYSIS

level since the country joined the euro zone. Investors have apparently concluded that the rescue is potentially a much better deal for the banks and their shareholders than for the government, its taxpayers and bondholders.

Many details of the banking bailout remain to be resolved — including which of Europe's rescue funds will supply the money. The one thing that is clear is that even though the money will be funneled to the banks, the government in Madrid will ultimately be responsible for guaranteeing that €100 billion, or $125 billion, adding to the Spanish government's already rising debt load.

That fact, more than any other, probably explains why there was heavy selling of Spanish government bonds on Monday and again Tuesday. The yield on Spain's 10-year bonds — an indicator of the government's borrowing costs and the risk of holding that debt — rose Tuesday to as high as 6.8 percent. That is approaching the level that led to bailouts for Ireland, Portugal and Greece.

With its banking industry in trouble, Spain probably would eventually have had no choice but to seek a rescue. And by not having to relinquish autonomy over its government budgets or spending, Madrid did strike a much better deal than other governments have with their bailouts.

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Bank deal gives hope to others in trouble

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LONDON

Cyprus could be first to follow Spanish in bid for aid with few strings

BY STEPHEN CASTLE
AND DAVID JOLLY

Designed to calm fears about the future of the euro, Spain's bank bailout has, in fact, done something very different. It has fueled the hopes of other troubled euro zone countries that they too can get aid with fewer of the draconian conditions blamed by many for deepening recessions across the Continent.

First in line may be Cyprus, which as an offshore financial center has a banking presence — and banking problems — far larger than its tiny size would suggest. It would like to follow Madrid's lead, and quickly, European officials acknowledged Tuesday. Greek and Cypriot newspapers reported that a request was possible by Wednesday, though a government official in the Cypriot capital, Nicosia, said that no formal request had yet been made.

"They are encouraged by what happened in Spain," according to one European official, who spoke on condition of anonymity due to the sensitivity of the issue. "They were afraid," he

FRANCISCO SECO/AP

Pedro Passos Coelho, Portugal's prime minister, is watching Spain's conditions.

added, that there would be tough conditions, "a whole program."

A bailout would make Cyprus the fifth euro zone member to need help since the currency bloc's crisis began in late 2009, when the Greek government owned up to having grossly misled other governments about the size of the hole in its public finances.

Even in Greece, politicians vying for power have taken heart from Spain's €100 billion, or $125 billion, deal. European officials and analysts warn that the countries' situations are vastly different, but Greek politicians are promising to renegotiate the terms of their rescue package after elections on Sunday, which are seen as central to the country's continued future in the euro zone.

In Ireland, too, the government is pressing for better terms for repaying the debt it took on while recapitalizing its banks. And, after the Spanish bailout was announced, the Prime Minister of Portugal, Pedro Passos Coelho, kept open the possibility of changes there too, while saying that none had been requested.

"We will be watching to see how a

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eliant women

government campaign to promote quick and inexpensive marriages is backfiring, experts say, because it cheapened an institution that is deeply anchored in Iran's culture and still viewed as an important rite of passage.

That has left the young women to develop strategies to fend for themselves, in a society that is still deeply suspicious of female sexuality. Shoukoufeh, who would not give her full name for fear of losing her lease, says that prying eyes often peek through the cracks of doors when she walks down the hallway. But she draws strength from her parents, who support her choice to live alone.

"They know I want to be independent," she said decisively. "They under-

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Bailout for Spain brings fears, not hope

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And yet, critics are noting that any upside from the arrangement will go to the banks and their investors. The potential downside will be the Spanish people's to bear.

"Unfortunately Spain didn't manage to reach one of its main goals in the negotiations, which was to have Europe bear part of the risk of rescuing the financial sector, without letting it fall instead directly onto the shoulders of the Spanish taxpayer," Luis Garicano, a Spanish economist who teaches at the London of School Economics, wrote in a blog entry. "Ultimately, those who lent to our financial system were the banks and insurance companies of northern Europe, which should bear the consequences of these decisions."

Fitch, the credit rating agency that downgraded Spain's banking industry nearly to "junk" status earlier in the month, warned Tuesday that the bailout loan could add 10 percentage points to Spain's government debt, raising it to about 90 percent of gross domestic product this year.

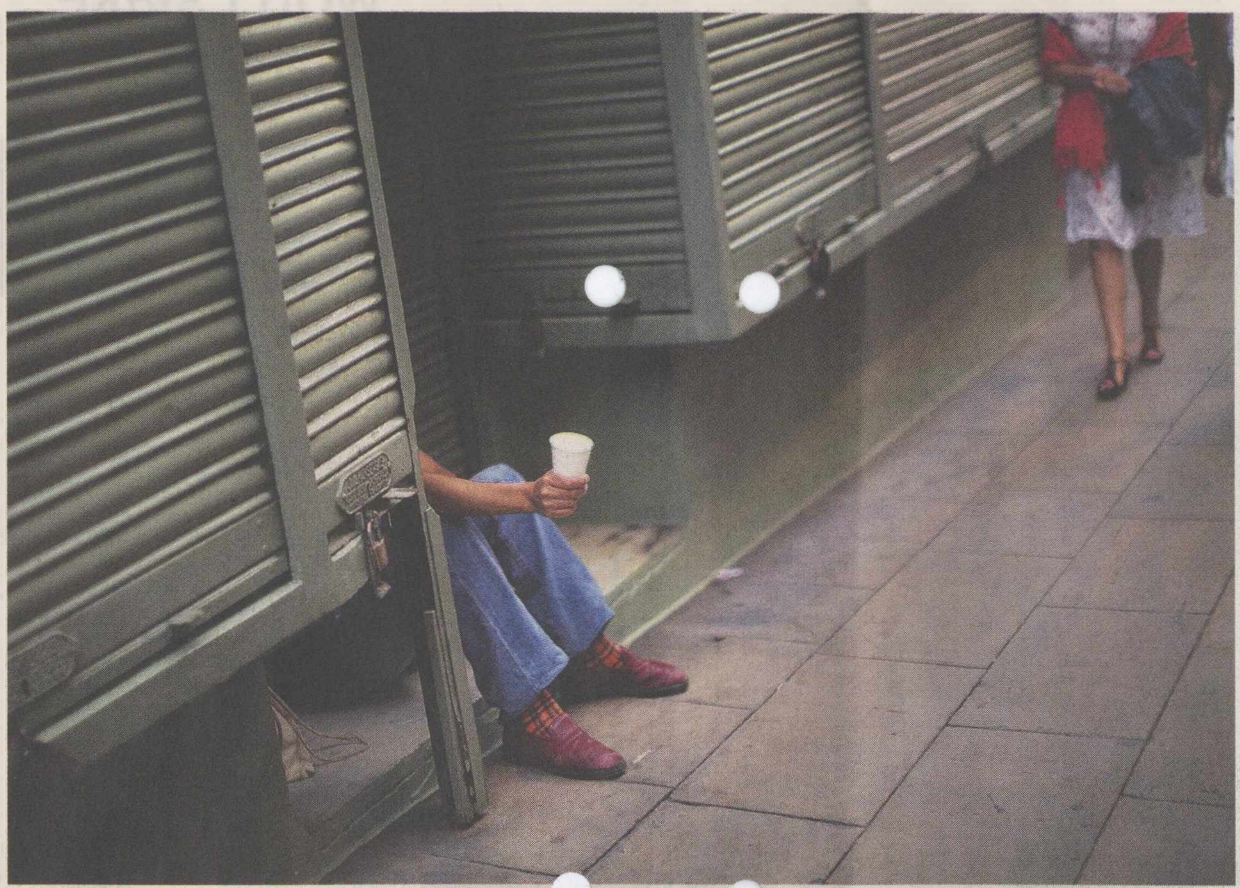
And even if Spain used only €60 billion of the bailout loan, Fitch, warned that would put Spain's debt "on a trajectory to peak at 95 percent of G.D.P. in 2015." Luis de Guindos, the economy minister, had warned as recently as April that debt would rise to 78 percent of G.D.P.

Some analysts, meanwhile, are questioning the rush by European finance ministers to push for Spain to accept a bailout before Greek elections next Sunday. Those elections could create deeper turmoil for the euro zone.

"The Europeans wanted to put a firewall between Greece and Spain, but they've accelerated things in a way that doesn't at all give confidence to the markets," said Xavier Sala-í-Martin, an economics professor at Columbia University in New York. Instead, he said, the deal "leaves the impression that everything was just improvised rather than planned properly."

Until last weekend, in fact, Mr. Rajoy's government had resisted formally requesting a rescue package, saying it wanted first to establish exactly how much money was needed to keep its troubled banks afloat.

Madrid had already grossly underestimated the problems at Bankia, a mortgage lender that was nationalized in early May and given a €4.5 billion government cash infusion. Less than two weeks later, the bank's overseers said it would need an additional €19 billion of new capital — a declaration that unsettled the markets and threatened to turn a steady outflow of investor money from Spanish banks into a torrent.



EMILIO MORENATTI/THE ASSOCIATED PRESS

A man begging in a street in Barcelona. Economists have suggested that the Spanish people will bear the downside of Spain's bank rescue.

Two consulting firms hired by the government to conduct stress-test audits of the Spanish banking industry, Roland Berger and Oliver Wyman, are not due to present their findings until June 21. Another four consulting firms, meanwhile, are auditing the 14 largest Spanish financial institutions, with those results not expected before the end of July.

Still, the International Monetary Fund on Friday evening in Washington, ahead of a release scheduled for Monday, published its assessment of Spanish banks, providing a rationale for the weekend rescue deal. The I.M.F. said that Spanish banks would need at least €37 billion in extra capital. The European finance ministers decided to lend out nearly three times that amount.

"Everybody moved too fast, based on too little information," Mr. Sala-í-Martin said. "The I.M.F. report comes out looking a little bit superficial, and certainly can't be used to conclude exactly how much money needs to be put on the table."

One thing the I.M.F. report did, however, is split Spanish banks into different risk categories, which in itself has fueled another debate within Spain's banking industry. Some of the best-situated commercial banks are now resisting receiving any of the European loans.

Spain and its European partners have not yet drawn up a memorandum of understanding for the deal. Many basic aspects of the loan also remain under discussion, even though Mr. de Guindos, the Spanish economy minister, has already said that Spain would receive "very favorable" terms for the European loan.

Among the few certainties is that the emergency loan will be channeled to the banks via the Fund for Orderly Bank Restructuring, which Spain set up at the onset of the crisis in 2009 and has already used to wipe out the losses of some smaller collapsed banks.

Meanwhile, the Spanish deal comes at an awkward time because Europe is in transition to a new emergency funding program, making it uncertain exactly how and when the money will be disbursed to Spain. Some holders of Spanish bonds are worried that Europe's loan will be given seniority over existing government debt. The new fund, known as the European Stability Mechanism, goes into effect next month and guarantees that its creditors have preferred status to other bondholders.

And even though Madrid obtained a much cheaper European lifeline for Spain's troubled banks than what it could have raised on the debt markets, opposition politicians are blaming Mr. Rajoy for letting the banking crisis spin out of control in the first place.

"What is there to make of somebody who has enough time to watch a soccer match but not to appear before Parliament?" asked Mr. Sala-í-Martin, the Spanish economist.

E.C.B. adds its own voice to calls for banking union

FRANKFURT

Integration is best way to shield taxpayers from future failures, it says

BY JACK EWING

The European Central Bank on Tuesday called for euro zone leaders to form a "banking union" to oversee its big banks, a move that would help shield countries and their taxpayers from the misfortunes of their troubled lenders.

A banking union might address one of the causes of the euro crisis — the tendency for sick banks to undermine entire countries. The costs of taxpayer-financed bailouts in Ireland, Spain and Cyprus, among other countries, were so large that it raised questions about the creditworthiness of national governments.

Such a union would also allow euro zone countries to share the financial burden of banking crises, perhaps avoiding a repeat of Spain's woes caused by Bankia and other ailing lenders.

In a report issued Tuesday, the E.C.B. said it envisioned that euro zone countries would share responsibility for regulating big banks and for managing a common deposit insurance fund. Countries would also create procedures for winding down terminally ill banks so that taxpayers would not have to bear the cost, the E.C.B. said.

Creating such a banking union would be a long process. But Vitor Constâncio, the vice president of the E.C.B., said a decision to begin work on an alliance would help to reassure financial markets.

"It would be a very powerful sign countries want to stick together in a monetary union," Mr. Constâncio said.

He praised an agreement forged by European leaders on Saturday to finance a rescue plan for Spanish banks. The €100 billion, or $125 billion, designated for the rescue should be more than enough, he said.

"One of the elements that was creating doubts in the market has been dealt with in a proper way," he said.

Mario Draghi, the president of the E.C.B., had previously expressed support for the idea of a banking union, but the statement Tuesday was the central bank's most explicit call for euro zone leaders to begin work on one.

But the E.C.B.'s position appeared to be at odds with that of the Bundesbank, the powerful German central bank.

Andreas Dombret, a member of the executive board of the Bundesbank, said Tuesday that a banking union would make sense only after euro zone countries had formed a broader fiscal union, a process that would itself take years.

"The recent proposals of a so-called banking union appear to be premature," Mr. Dombret said in London, according to a text of his remarks. The Bundesbank is part of the European system of central banks led by the E.C.B., but the German institution has often diverged from its peers on policy issues.

The E.C.B. proposal came as part of the bank's twice-a-year assessment of risks facing the monetary union. The report acknowledged that stress in the euro zone had risen again after a respite earlier this year when the E.C.B. issued €1 trillion in inexpensive, three-year loans to banks.

The report argued that the extraordinary loans helped because they removed doubts that banks would fail for lack of market funding.

"They had a lasting effect on the situation," Mr. Constâncio said.

HANNELORE FOERSTER/BLOOMBERG

Mario Draghi, president of the E.C.B.

The 135-page report also provided data on a wide range of risks but avoided discussing the one that may be foremost on investors' minds: The possibility that Greece could leave the euro zone.

"We don't see that Greece will exit the euro area," Mr. Constâncio said.

In any event, he said the fallout would be too tricky to forecast.

"It would be very difficult if not impossible," he said, "to assess the consequences of the exit of a country."

Hopes for better terms in euro zone

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specific program for Spanish banks will work, and if some exceptional conditions could be shared with other countries that are under assistance, I have no doubt it will happen," he said.

Officials in Brussels insist that Spain — which has already undertaken significant austerity measures — was a special case and that no general shift of strategy is under way.

"People in Greece and Ireland were always going to use the terms given to Spain to say 'you have to renegotiate our terms,'" said one E.U. official not authorized to speak publicly. "Our response is that this is a totally different situation."

If the Spanish bank bailout does not relieve pressure on borrowing costs, the immediate concern could switch to the possibility that Spain could require a bigger rescue later in the year. Also worrisome for officials and investors is the fear that Italy — the third-largest economy in the euro zone, after Germany and France — will itself end up needing help.

The calls to relax some of the austerity highlight the impact of Europe's economic slowdown, which has left some countries trapped in a downward spiral of budget cutting, low growth and reduced tax revenues. The debate also underlines how much the euro zone has shifted its stance on rescues since its first bailout for Greece, negotiated in 2010, in which creditor countries insisted that the Greek government should not benefit from concessionary interest rates.

Were the government in Athens to receive something better than the market rate, it could be seen as a reward for its past profligacy, officials argued at the time. Since then, worries about moral hazard have been subordinated to the more urgent need to douse the flames threatening to engulf the euro zone.

Meanwhile, the euro zone's bailout fund has gained new, more flexible, instruments, allowing it to extend credit lines and to offer financing for bank recapitalization, although via national governments. Spain's bailout will be the first to use these new tools.

At the same time, the European Union has gained new powers to control budget deficits in its member countries, effectively increasing surveillance of all the economies of the euro zone whether they are in financial trouble or not.

Analysts cautioned, however, that the conditions for Spain's bailout — which still remain to be completed — might not be a template because the Madrid has been taking tough budget-cutting measures since 2010.

"It is inevitable that, in this process, you have a learning curve," said Nicolas Véron, a senior fellow at Bruegel, a research group in Brussels, "that the instruments evolve over time and after some of the early cases. There is no level playing field."

E.U. aid is not necessarily "something bad or shameful."

"Any new programs will be framed in the context of a European recession, which was not the case a year or two ago," he added.

And in the realpolitik of the European Union economic size is a consideration. Spain, as one of the euro zone's biggest economies, is in a better condition to bargain with the bloc's authorities than such smaller countries as Greece, Ireland, Portugal — or Cyprus.

Meanwhile in Dublin, the Sinn Fein Party's finance spokesman, Pearse Doherty, said in a statement after Spain's application that the loans were to be provided "at a lower cost, with no additional austerity or loss of sovereignty." The Irish government, he added, should explain "why it was not able to secure these kinds of terms when the Spanish government could."

In Greece, the two parties leading the election race, the conservative New Democracy and leftist Syriza, have suggested the Spanish pact was a sign that Athens could be cut some slack in renegotiating its own bailout.

But Evangelos Venizelos, the former Socialist finance minister who negotiated the country's debt deal with creditors and saw support for his Pasok Party crumble as a result, said Monday that the Spanish deal showed European leaders were merely "preparing a firewall to deal with whatever happens in Greece."

Until now, the government of Cyprus has been reticent about any request for a bailout, preferring to seek help from Russia rather than from its euro zone allies. But with Cyprus due to take over the rotating European union presidency on July 1, it wants to get the issue resolved before then, said one E.U. official who spoke on condition of anonymity due to the sensitivity of the issue.

The Republic of Cyprus has a population of just over 800,000, if the Turkish population of the northern part of the divided island is excluded, and an annual gross domestic product of about $24 billion. But it is Cyprus's outsized banking sector that may be its undoing.

Bank of Cyprus and Cyprus Popular Bank, the country's two largest lenders, now need billions of euros to rebuild their capital after they had to mark down the value of their holdings of Greek government bonds and loans to Greek businesses and consumers.

Moody's Investors Service has estimated that bailing out the banks would cost the government about 20 percent of G.D.P. Analysts say there is no possibility of Cyprus being able to tap bond market investors for that amount.

Last year, the Russian government lent Cyprus €2.5 billion at a below-market interest rate of 4.5 percent.

But the finance minister of Cyprus, Vassos Shiarly, told a parliamentary committee Monday that use of E.U. aid was not necessarily "something bad or shameful," the Cyprus News Agency reported, and said that officials had held discussions with the Union about how the support mechanism operates.

"When a country appeals to the support mechanism, it considers everything, including the needs that might transpire over the coming period," Mr. Shiarly said, holding out the possibility that Cyprus might seek a broader bailout.

But a government spokesman, Stefanos Stefanou, told the state radio station RIK that, "if Cyprus seeks support from the mechanism, it will be for its banks and not for its financing needs."

David Jolly reported from Paris. Jack Ewing contributed from Frankfurt, Paul Geitner from Brussels and Niki Kitsantonis from Athens.

JARED MOOSSY FOR THE INTERNATIONAL HERALD TRIBUNE

...wall along the dividing line between Turkish and Greek sections of Nicosia. Cyprus would ...e to solve its banking problems before assuming the presidency of the European Union.