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Inter

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Wanted: Buyers of long-term euro debt

LONDON

Relatively good numbers aren't helping troubled economies sell bonds

BY LANDON THOMAS JR.

As Europe slouches toward a monetary union that aims to force euro zone governments to cede control over their banks and budgets, a crucial question remains unanswered: how to persuade investors to buy, and hold for the long

NEWS ANALYSIS

term, the bonds of economies at risk like those of Italy and Spain.

Both countries have debt and deficit levels that are no worse, and are in some cases better, than those of Britain, Japan and the United States. But because they cannot devalue their currencies and must instead impose growth-sapping economic measures to regain competitiveness, their bonds have traded as if their economies are nearly insolvent. Meanwhile, the securities of highly indebted Britain, for example, are snapped up with abandon.

It is a paradox that lies at the heart of the European debt crisis. On Friday at its most recent summit meeting, Brussels took a halting first step toward addressing this issue permanently. Euro zone leaders proposed that Europe's current and future rescue funds might buy Italian and Spanish bonds as long as these countries fulfilled Germany's austerity demands and met debt and deficit targets. The market, expecting more waffling, jumped and the yields on 10-year Spanish and Italian bonds dropped sharply as investors celebrated the prospect that Europe might become a buyer of last resort of its beaten-down bonds.

Still, the euphoria Friday notwithstanding, economists and market participants remain doubtful that the bond market fears can be permanently assuaged until the European Central Bank intervenes with the force and conviction shown by its peers in the United States and Britain.

Paul De Grauwe, a Belgian economist at the London School of Economics, says he believes that the latest step will not be enough. Mr. De Grauwe has written extensively on how the cycle of fear and panic in the bond markets is pushing countries that may not need bailouts to ask for them.

The euro zone's temporary bailout fund, the European Financial Stability Facility, which now has €248 billion, or $314 billion, at its disposal and must first raise the money on the bond market, does not have the firepower to convince skittish investors that Europe is serious, he said. Italy and Spain alone have nearly €2.5 trillion in sovereign bonds outstanding.

Mr. De Grauwe proposes instead that the European Central Bank announce that it will be an aggressive buyer of

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LOTS OF UNKNOWNS IN CRISIS RESPONSE
An E.U. plan for curbing banking and budget abuses has prompted more questions than answers. *PAGE 14*

Blanks to fill in as E.U. responds to bank crisis

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of an institution that has a reputation for rigor: the European Central Bank. The bank also is the one institution in Europe with enough financial firepower to ward off an economic catastrophe.

After the summit meeting, Mario Draghi, the central bank's president, told reporters that "allowing the E.C.B. to take up supervisory tasks for the euro area" was among decisions made by leaders that were "fully in line" with the bank's mandate. Placing a head office for the new agency at the E.C.B., and delegating officials from the agency to work alongside national supervisors to ensure that systemic problems are detected ...ier, could mean hiring hundreds of extra staff members to cope with hands-on duties like on-site visits at banks.

JOHN THYS/AFP

Mario Draghi, president of the E.C.B., which could wind up with greater powers.

"Considering the options, the E.C.B. probably is the best choice for this supervisory role, yet this also could be a poisoned chalice for the E.C.B.," said Daniel Gros, the director of the Center for European Policy Studies, a research organization.

"We know there are pockets of weakness in European banking, and uncovering that there's more dirt in those balance sheets doesn't exactly make you popular," Mr. Gros said. "My guess is that E.C.B. has some very hard choices in front of it about the extent of its supervisory role."

To succeed, the E.C.B. will have to do a much better job than the European Banking Authority, whose powers ha been severely limited by its structu and its lack of a mandate to carry out rect supervision of banks

"The E.B.A. has lost a bit of credibili frankly, after the stress tests didn't c tect such grave problems, particular in Spain," Mr. Pascual of Barclays saic

The plan announced Friday mornii was part of a larger bargain at the tw day summit meeting.

Countries led by Germany agreed allow a new, permanent European ba out fund to recapitalize banks directly - a major demand by Italian and Spanis leaders who want aid for their lender without deepening their public debt. I exchange, Germany and its allies wo more rigorous centralized authorit over lenders. The rescue fund, the Euro pean Stability Mechanism, with an ef fective firepower of about €500 billion or $633 billion, should take effect in coming weeks once it is ratified by enough member states.

The Union also has been drawing up plans for a so-called banking union, which would include rules to shore up—or wind down — troubled banks in euro zone member countries. Those proposals would require member states that have not yet done so to set up so-called resolution funds, possibly in concert with other euro zone countries. The national authorities would be required to intervene in troubled banks by firing management or requiring sales.

But those plans still keep much decision-making at the national level, and some analysts warned over the weekend that the new supervisory agency could be powerless to fix problems it detected unless it had the full authority to require recapitalization, sell-offs and even closure of banks.

"We now know that the European Stability Mechanism should have the money to recapitalize banks," said Guntram B. Wolff, the deputy director of Bruegel, a research organization. "But who is going to decide how to split up banks, and who is going to decide which creditors take the losses?"

"We still don't really know who would be in charge of bank resolution, and yet that's as important as supervision if you want to ensure a stable banking system and a stable euro zone," Mr. Wolff said.

Views

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EUROPE'S MUDDLED WAY

European leaders have opted for crisis management, not crisis resolution. The euro zone needs far-reaching reform.

Judging from the strong rally in global financial markets, European leaders meeting last week in Brussels managed once again to say and do enough to quell the euro-zone debt crisis. For a day, anyway.

With Spain in danger of collapse and Italy tottering behind it, the meeting was less a show of solidarity than a forum for emergency consensus. The major agreements revolved around ways to use Europe's bailout funds more flexibly. Most notably, the leaders agreed to provide bailout money directly to Spain's banks, rather than loaning the money to the Spanish government, a sensible move that is intended to stabilize the banks without driving the government deeper into debt. They also agreed to ease the terms under which bailout money could be used to buy the bonds of vulnerable nations, like Spain and Italy, which have seen their borrowing rates rise as their economies have weakened. The leaders also agreed to spend €130 billion on infrastructure projects and other efforts to boost growth and employment.

But what they did not address fully — and what is crucial — is how to let up on the crushing austerity, championed by Germany, that has been imposed on weaker economies in exchange for bailout aid. The more liberal uses of bank bailout funds, for instance, are aimed at countries that are already undertaking harsh budget cuts. The growth-and-jobs spending is expected to use existing European Union funds, so it will not provide a substantial additional stimulus to ailing economies.

There is also reason to doubt that the new bailout financing mechanisms will work as planned. The new approaches represent a concession by Germany, which previously insisted that bailout aid be channeled only through governments that agree to austerity measures.

As a condition of the deal, the leaders agreed to establish a new euro-zone banking supervisor. That is a positive step in the direction of a banking union that could strengthen the common currency. But it will take until the end of the year, at the earliest, to set up the new body, which means some delays in directly recapitalizing the banks.

The euro zone needs far-reaching reform, including a broad plan for balanced economic growth, issuance of jointly backed debt and greater institutional integration. The latest agreement, like those before it, may buy some time. The question is whether Europe will use it to carry out the needed changes.

The monster that won't go away

Hugo Dixon

POLITICAL ECONOMY

THIERRY CHARLIER/GETTY IMAGES-AFP

Activists demonstrated last week outside the euro zone summit meeting in Brussels, where European leaders agreed to a bailout fund.

Cuando despertó, el dinosaurio todavía estaba allí. "When [s]he awoke, the dinosaur was still there."

This extremely short story by the Guatemalan writer Augusto Monterroso sums up the state of play on the euro crisis. The summit meeting last week took important steps to stop the immediate panic. But the big economies of Italy and Spain are shrinking and there is no agreed long-term vision for the zone. In other words, the crisis is still there.

The summit meeting's decisions are not to be sniffed at. The agreement that the euro zone's bailout fund should, in time, be able to recapitalize banks directly rather than via nation-states will help break the so-called doom loop binding troubled lenders and troubled governments. That is a shot in the arm for both Spain and Ireland. Meanwhile, unleashing the bailout fund to stabilize sovereign bond markets could stop Italian and Spanish bond yields from rising to unsustainable levels.

Insofar as this restores confidence, Spain and Italy could avoid the need to obtain full bailouts or restructure their debts. And Ireland, which is in a full bailout program, could leave that and fund itself in the market again.

The immediate market reaction Friday was positive. Spanish 10-year yields fell to 6.3 percent from 6.9 percent, Italian yields dropped to 5.8 percent from 6.2 percent and Irish yields plunged to 6.4 percent from 7.1 percent. But these borrowing rates are still high. And, with the exception of Ireland, the market movements Friday take prices back only to where they were in May.

What's more, as the details of the agreement are picked over, some of the market euphoria may well fade. After all, Germany, the zone's paymaster, has not written a blank check.

Take the bank recapitalization plan. Madrid is planning to inject as much as €100 billion, or about $127 billion, into its banks, and Dublin has already sunk €64 billion into its lenders. The big question is whether the euro zone will reimburse them the full amount invested, given that the stakes in the banks are not worth as much. That seems unlikely. But if the full sum is not paid, the debt relief for Spain and Ireland may not be as big as some are hoping.

As the details of the agreement are picked over, some of the euphoria may well fade.

Or look at the market-stabilization mechanism. The euro zone bailout fund's resources are limited, so it might not be able to keep Italian and Spanish borrowing costs down in the long run. What is more, to gain access to this mechanism, a country would have to write a memorandum of understanding setting out its policy commitments to overhaul its economy. This means that there will still be some stigma attached to the plan — which probably explains why Rome and Madrid are not rushing to sign up.

To point out that Chancellor Angela Merkel of Germany has not agreed to a blank check is not to criticize the summit compromise. It is essential that Mario Monti of Italy and Mariano Rajoy of Spain take further measures to restore their countries' competitiveness. Both prime ministers have lost momentum in recent months and need to embark on a second wave of reforms. If they are given money for nothing, they will be under no pressure to do so.

The continued uncertainty about exactly how bank bailouts and market stabilization will work, however, means that the summit meeting did not produce a neat package. As the loose ends are tied up, there could be further wrangling that unnerves investors.

Meanwhile, Italian and Spanish economies are continuing to shrink. This means that they will not hit their deficit-reduction targets and that their debts and unemployment will rise further.

To be fair, the summit meeting did come up with a €120 billion growth pact. But it is unlikely that this will move the needle. More may need to be done to shore up growth. The obvious solution would be still looser monetary policy from the European Central Bank.

Recession also has political consequences, especially in Italy, where elections are due next spring at the latest. Both Beppe Grillo, a comedian whose populist Cinque Stelle, or Five Star, movement has come from virtually nowhere to 20 percent in the opinion polls in recent months, and Silvio Berlusconi, the former prime minister, are playing the euroskeptic card. In the circumstances, Mr. Monti's technocratic government will struggle to gain political support for any more changes. Investors and Italy's euro partners will, in turn, worry about what comes after him.

The euro zone leaders also agreed, in principle, on the first step toward a long-term vision for the region: the creation of a single banking supervisor "involving the E.C.B."

If this cleans up the mess in large parts of the European financial system, it will be good. But some countries will not wish to surrender control over their banks to a centralized authority, and so it is quite possible that some messy fudge will emerge.

If the question of a single banking supervisor is likely to be subject to future disputes, even more disagreement can be expected over whether there should be a full political and fiscal union. Some countries, like Germany, want much more common decision-making, but others understandably fear the loss of sovereignty. Meanwhile, many weaker nations want to pool their debts — an idea rightly rejected by Mrs. Merkel.

The people of Europe are not ready for full political union. So the best solution would be to keep the loss of sovereignty and debt-sharing down to the minimum. But the summit meeting put these big issues into play.

The dinosaur is less terrifying than it was a few weeks ago. But it is still there.

Hugo Dixon is the founder and editor of Reuters Breakingviews.