FRANKFURT

It wasn't just Greece: Hubris across Continent also played a fateful role

BY JACK EWING

The debate about how to distribute the cost of preserving the euro often revolves around a fundamental question that is unspoken but implicit: Who caused this infernal crisis anyway?

80

A hint: It wasn't just the Greeks.

In Germany, however, the prevailing

NEWS ANALYSIS

stereotype is that the dissolute Greeks squandered the privileges of euro zone membership. There is a palpable resentment among German taxpayers who feel they are being asked to pay for the sins of the Greeks as well as the Spaniards and Italians.

It is, of course, not that simple. While it is true that a series of Greek governments bears a large share of the guilt for the euro crisis, for mismanaging their economy and finances, there are plenty of other culprits. They range from the German and French banks that lent Greece money and fueled the Spanish housing bubble to the European political leaders who, more than a decade ago, introduced the euro even though they knew it had basic flaws.

The circle of perpetrators could also include the fickle bond investors who underpriced the risk of Greek debt before 2010 and whose volatile reaction to even minor events has lately been wreaking havoc with Spanish and Italian borrowing costs and, by extension, those countries' economies. It could include the bank regulators and national governments that created incentives for European banks to load up on European government bonds.

The popular debate, though, seems to revolve around cultural stereotypes. The southerners are dolce vita spendthrifts, while the Germans — and sometimes the Finns, Austrians and Dutch — are scrooges with no sense of European solidarity. Some of the stereotypes are more offensive: The German chancellor, Angela Merkel, has even been portrayed in the Greek and Italian media as a latter-day Hitler.

"The blaming game that dominates the political debate in Europe is a clear indicator that cross-border policy cooperation in Europe has ground to a halt," said Giancarlo Corsetti, a profes-

EURO, PAGE 9

E.U. set to propose tighter bank oversight

BRUSSELS

BY JAMES KANTER

The European Commission on Friday set a target date of Sept. 11 to announce proposals to overhaul banking regulation in Europe, a key step in shoring up the euro zone against future crises.

The establishment of a new pan-European regulatory system is a precondition for countries that use the euro to tap European bailout funds to recapitalize their banks without taking on more sovereign debt — breaking the so-called doom loop in which frail banks can endanger national finances and push countries toward full bailouts.

Spain, which has won approval for a multibillion-euro recapitalization of its banks, has already indicated it would like to avail itself of euro bailout funds.

European leaders including Chancellor Angela Merkel of Germany have made it clear that countries wishing to use bailout funds to recapitalize banks directly would only be able to do so once there was better supervision and control over the banks that benefited from such rescues.

The commission, the E.U. executive body, was charged with drafting the banking proposals after European Union leaders, at a summit meeting in June, committed to giving the European Central Bank a leading role in the new supervisory system.

To work properly, the new banking regulator will need far greater powers than the existing European Banking Authority, which is only about two years old. The banking authority lost credibility after it conducted two rounds of stress tests on European banks but failed to highlight the sector's looming problems, particularly those in Spain.

In a statement, the commission said it would lay out the new supervisory role for the E.C.B. and its relationship with national supervisors. Putting the E.C.B. in charge could dramatically diminish the scope for political interference in banking regulation by reducing the ability of countries to protect favored lenders.

The commission also said it would address whether banks outside the euro area would also fall under the purview of the new system, and to what extent the existing banking agency would maintain a supervisory role.

The commission said its goal was to make the proposals on Sept. 11, but the date still needed final confirmation. It said the new system was to enter into force early in 2013 although analysts have indicated there could be delays.

One of the thorniest questions for the commission is how many banks the E.C.B. will oversee, and whether those banks will include politically sensitive lenders like savings banks in Germany.

The proposed regulations will still be "subject to debate and agreement among the member states, and that is likely to prove contentious," Mujtaba Rahman, an analyst for the Eurasia Group, wrote in a note on Thursday.

Because "many difficult issues remain," the result is that "implementation could be delayed, in turn delaying the direct recapitalization of Spanish banks," Mr. Rahman wrote.

Another key step in the process of shoring up the euro is the authorization of a permanent European bailout fund, the European Stability Mechanism, or E.S.M., to succeed the current temporary bailout fund, the European Financial Stability Facility. The permanent fund, capitalized at €500 billion, or $625 billion, was due to come into operation over the summer but is now awaiting a decision on its legality by the German constitutional court, due on Sept. 12.

The delay in establishing the E.S.M. is also holding up action by the European Central Bank to buy bonds of troubled euro countries in an effort to bring down borrowing costs and help them refinance their budgets. The E.C.B. president, Mario Draghi, said this month that the central bank was working on a bond-buying plan, but it is thought to be unwilling to proceed without the bailout fund in place.

Jack Ewing contributed reporting from Frankfurt.

Plenty of blame to share for Europe's debt crisis

EURO, FROM PAGE 1

sor of macroeconomics at the University of Cambridge.

The question of blame was in the air this week as Ms. Merkel, along with the French president, François Hollande, and other euro zone leaders confronted the likelihood that Greece will need more help than it has already received in order to avoid a chaotic exit from the currency union.

The debt crisis has its roots in decisions made in the 1990s when European leaders were designing the euro. Many economists warned then that Europe still lacked key elements necessary for a common currency to work, like a joint European bank regulator and a system for dealing with troubled financial institutions.

Those shortcomings came into painful relief after Irish banks began to get into trouble in 2006. Ireland had to bear most of the cost of the bailout by itself, precipitating a national debt crisis from which it is still recovering. Spain now faces a similar problem with a banking crisis it cannot afford to fix on its own.

The euro zone also lacked an effective means to discipline members that violated debt and deficit spending limits set by treaty. Several countries soon exceeded them. In fact, Gerhard Schröder, German chancellor until 2005, was one of those calling loudest for the rules to be watered down so he would not have to cut government spending.

These flaws were well known. But European leaders, led by France and Germany, proceeded with the common currency anyway, on the theory that they could deal with its shortcomings later. Now they are trying to create a common bank regulator and a stricter fiscal regime amid a crisis much larger than anything they ever imagined.

Greece was the addict, European banks — and especially French and German banks — were the dealers.

"When we started the euro we knew the construction was not good," said Mr. Corsetti, the Cambridge economist. The idea that they could deal with flaws as needed "was a hubris that turned out to be very costly."

It is true that, before and after joining the euro in 2001, Greece obscured the true extent of its debt, sometimes with the help of financial transactions engineered by Goldman Sachs. But it was not exactly a secret that Greece was fiddling with the numbers. Eurostat, the European Union statistics agency, warned about it as early as 2004.

Yet European banks, especially French and German banks, continued to lend Greece money. At the end of June 2009, just before the debt crisis exploded, Greece owed French banks €76.5 billion, or $96 billion, and German banks €38.6 billion, according to the Bank for International Settlements. The figures include both government and private sector debt.

If Greece was the addict, these banks were the dealers. German and French banks also lent huge sums to Spain and Italy.

"It was German government decisions and German banks — and Austrian banks and Dutch banks and Finnish banks — who lent the money to all these countries," Adam S. Posen, a U.S. economist who is an external member of the Monetary Policy Committee of the Bank of England, said on BBC television this past week.

Germany lent the money so it could be used to buy German exports, Mr. Posen said. "Germany has been running a scheme in their own interests," he said.

Now Germany is struggling to hold the euro zone together. Ms. Merkel met in Berlin on Friday with the Greek prime minister, Antonis Samaras, and pledged to support Greece as it tries to mend its economy and stay in the currency union. Spain will also need money to rescue its banks. And Europe must decide how to contain borrowing costs for Spain and Italy so that they do not join Greece on the list of endangered euro members.

But Ms. Merkel is constrained by the widespread view among her voters that Greece does not deserve more help.

Three-quarters of Germans oppose easing the terms of Greece's two international bailouts, according to a poll this week for the television broadcaster N24 by Emnid, a research firm. More than two-thirds think that Greek leaders are not doing all they can to cut spending and overhaul the economy, according to the poll.

European Union and national regulators also helped midwife the crisis. They encouraged banks to buy lots of debt from Greece and other European countries. Under E.U. rules, all euro zone debt was considered to be risk-free. That meant that banks did not need to hold any capital in reserve as insurance against losses on their European sovereign debt.

In the eyes of many policy makers, economists and citizens in the northern countries, the only way Spain and Italy will hold down their borrowing costs is by convincing bond investors that they have their spending under control and are diligently overhauling their economies. Without market pressure, the German central bank and others have argued, politicians in troubled countries will not take the steps that are needed.

Mr. Corsetti argued, though, that part of the premium that investors were now demanding for Spanish and Italian debt reflected a lack of cohesion by euro zone members, not just the countries' domestic policies. In fact, Spanish and Italian borrowing costs have fallen in recent weeks as euro zone leaders displayed signs of more effective cooperation.

"Once the policy cooperation is there, things will look much more manageable," Mr. Corsetti said. "There is very little room for stereotypes if we want to have a solution."

ANGELOS TZORTZINIS/BLOOMBERG NEWS

A vendor in Athens. Antonis Samaras, the Greek prime minister, has vowed that his country will pay back its debt, saying Friday that "what Greece needs is a chance at growth."

Merkel says Greece must stay with euro

BERLIN

Show of support comes as Athens asks Europe for more 'breathing room'

BY MELISSA EDDY

Angela Merkel, the German chancellor, pledged Friday to support the new Greek government as it struggled to overhaul its economy, saying that the heavily indebted country must remain in the euro zone.

Ms. Merkel met in Berlin with the Greek prime minister, Antonis Samaras, for his first official visit abroad. She expressed confidence that the government in Athens "will do what it takes to solve the problem in Greece," and pledged to focus on healing the rift that has grown between the two countries.

"What I want is to bring the two realities that have emerged back together into one reality," Ms. Merkel said. "Now it's the task of those who have political responsibility in Europe to bridge that gap. I want Greece to stay in the euro zone and that's what I'm working for."

The message was a clear signal to those Germans, including some members of her own government, who have argued that the easiest way to resolve Europe's sovereign debt crisis is for Greece to leave the euro zone. Volker Kauder, who leads Ms. Merkel's party in Parliament, told the public broadcaster ZDF on Friday that a Greek exit "would not be a problem for the euro" because sufficient measures were in place to prevent contagion spreading to other weak economies in the euro zone.

Such calls have irritated Mr. Samaras, who vowed that his country would pay back its debt, but insisted that his country needed "breathing room" to revive its economy and meet targets agreed to in exchange for a €173 billion, or $217 billion, international bailout.

"The recovery of the economy is of critical importance if we are to achieve our goals," Mr. Samaras said. "What Greece needs is a chance at growth."

Mr. Samaras declined to specify how much more Greece might need to meet its targets, but said he was confident that a progress report from Greece's international lenders, known as the troika — the European Commission, the European Central Bank and the International Monetary Fund — would show that Athens had "produced results" in its reform efforts.

"We of course expect from Greece that the commitments that were made be implemented."

That report is due next month and is expected to provide the basis for the next round of decision-making on Greece's future during an E.U. summit meeting scheduled for Oct. 18-19.

With Spain waiting in the wings for help from Europe's bailout funds and Italy facing an election in the spring, European leaders are emphasizing the importance of meeting strict conditions in exchange for aid.

"To win back confidence, we must fulfill expectations," Ms. Merkel said after her meeting with Mr. Samaras, "and so I made clear in the talks that we of course expect from Greece that the commitments that were made be implemented, that deeds follow words."

From Berlin, Mr. Samaras traveled to Paris, where he was to hold talks on Saturday with President François Hollande. The French leader met with Ms. Merkel on Thursday to plan a coordinated response to Mr. Samaras.

Mr. Samaras, an economist, said he also recognized that winning back trust would be necessary if his country was to move ahead. "We are a proud country. We don't want to rely on borrowed money," Mr. Samaras said. "We want to stand on our own two feet."

U.S. market leads pack in bounce back

Floyd Norris

OFF THE CHARTS

The U.S. stock market has returned to record territory — at least when dividends are included — but few other stock markets have done so. A survey of the major markets of the world indicates that North America was the best place to be for investors who chose to ride out the credit crisis, while the euro zone was clearly the worst.

The emerging markets that aroused the most envy during the boom — the so-called BRIC countries of Brazil, Russia, India and China — have done poorly.

The accompanying chart shows the performance of 30 stock markets around the world from Oct. 31, 2007, when the world stock market peaked, through March 9, 2009, when it hit bottom during the worst part of the financial crisis.

The chart is based on MSCI indexes, which include the major stocks of each country and are calculated in the same fashion. The figures reflect performance in dollars rather than in local currencies. Included are the 23 countries that MSCI classified as developed when the market peaked in 2007, as well as seven prominent emerging markets. They reflect total returns, assuming reinvestment of dividends.

The countries farthest to the right on the chart suffered less than others during the 2007-9 bear market, while those higher on the chart have performed the best over all since the 2007 peak.

Excluding dividends, no major market is above its 2007 peak.

Over all, the MSCI all country world index fell 58 percent in the decline and remains 13 percent below the 2007 peak, even assuming dividend reinvestment.

The worldwide nature of the 2007-9 plunge is illustrated by the fact that each of the 30 markets lost at least half of its value by the time markets bottomed. Only two of the countries — Japan and Switzerland — declined less than the U.S. market, which fell by 55 percent.

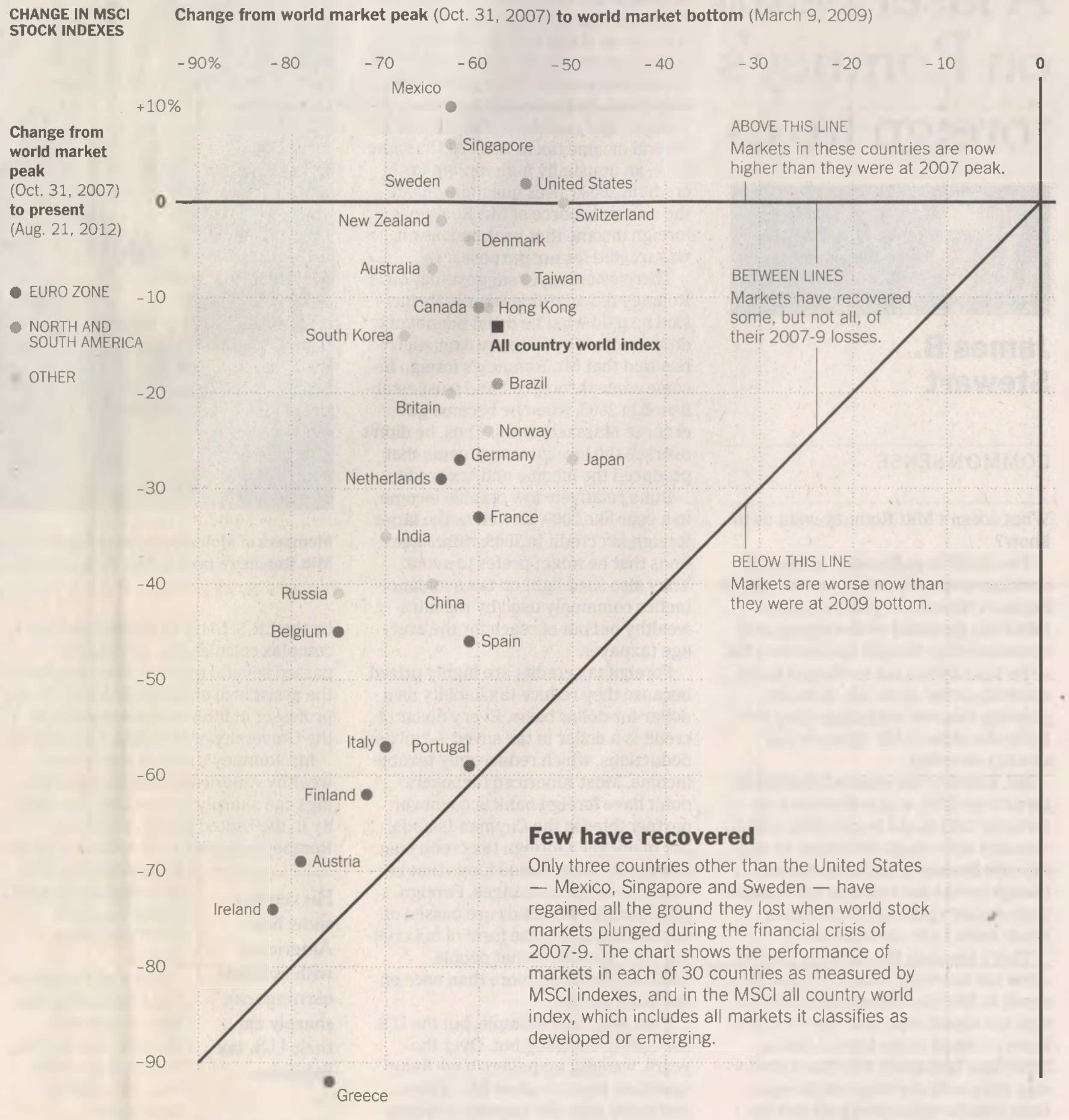
The U.S. index was 2 percent higher this past week than it was at the peak more than four years ago. That is hardly the type of performance that would have seemed attractive then, but only Mexico and Singapore have done better over the stretch. The Swedish market is also up a bit from the 2007 peak.

At the other end of the spectrum is Greece, the only market that is now lower than it was at the 2009 low. Recessions ended in most other countries, but the Greek depression shows no signs of ending. The country is getting by with international assistance, but its membership in the euro zone means that it has been unable to stimulate its economy through currency devaluation.

It comes as no surprise that the other troubled euro countries are also near the bottom of the performance list, but even the euro zone members that have done relatively well have suffered. The 11 euro states that are included are all among the bottom 14 countries in performance since the 2007 peak. The other three are the BRIC countries excluding Brazil.

Why has the United States done so (relatively) well? Part of the answer may be the belief that dollar-denominated assets are a haven at a time of currency instability. In addition, the American economy, while hardly soaring, has performed better than most, with corporate profits especially strong. There are signs that those profits are coming under pressure, however, which may make further gains more difficult to achieve.

It was, of course, the excesses of the U.S. financial system that led to the crisis, so it must rankle many in Europe and Asia that the American market appears to have done one of the best jobs of weathering the subsequent storm.



Source: MSCI via Bloomberg