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# Big worry for Europe: A double meltdown

LONDON

## A 'Lehman moment' risk if Greek and Spanish problems peak together

BY LANDON THOMAS JR.

In a season of nightmare projections for Europe, this one could be the scariest: Greek leaves the euro currency union at the same time Spain's banking system is collapsing.

In many ways, the market convulsion

*NEWS ANALYSIS*

last week was a test run for those crises, as political deadlock in Greece and mounting fears over the health of Bankia, one of the largest consumer banks in Spain, converged. The credit ratings agency Moody's Investors Service downgraded the entire Spanish banking sector Thursday.

As investors gird for another challenging week, they will be hoping European leaders in Brussels, if not Frankfurt where the European Central Bank is based, can finally start to map out an action plan. It is not clear that policy makers have many good options.

The money available to Europe within its main bailout fund, about €780 billion, or $997 billion, would not be enough to handle the twin calamities of a Greek euro exit and a Spanish banking implosion.

And despite recent statements from Germany and from leaders of the Group of 8 industrialized nations meeting in the United States over the weekend to encourage economic growth in the euro zone, the European tax-paying public may have little desire to continue financing the debt disasters of other countries.

"When you have Greece and Spain happening at the same time, the problem becomes exponential and very, very dangerous," said Stephen Jen, a former economist at the International Monetary Fund who runs a hedge fund in London. "So far, the policy has been to buy time and build a firewall — but that just makes the cost bigger. There is just no good ending here."

The numbers do look dire.

Stephane Deo, an economist at UBS, estimates that the cost of a Greek exit to European taxpayers would be €225 billion, assuming Greece defaulted on the money it now owes to European public institutions.

But, he says, the real fear is that while that was happening, the slow-motion collapse of Spanish banks from toxic real estate loans could suddenly turn into a fast-moving bank run, as depositors pulled out their money.

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**GERMANY EASES ITS POSITION ON DEBT**
Under pressure from G-8 leaders, Chancellor Angela Merkel seemed to give ground on austerity. *PAGE 18*

**KEYS TO THE EURO ZONE'S SURVIVAL**
The euro zone requires flexibility as part of its crisis-survival plans, Hugo Dixon writes. *PAGE 22*

# Rest of G-8 presses Germany over growth

CAMP DAVID, MARYLAND

## Obama gains support for stance that austerity cannot fit all equally

BY HELENE COOPER

Leaders of the world's richest countries have banded together to press Germany to back more pro-growth policies to halt the deepening debt crisis in Europe.

At a meeting of the Group of 8 developed nations Saturday, President Barack Obama for the first time gained widespread support for his argument that Europe, and by extension the United States, cannot afford a one-size-fits-all approach emphasizing austerity.

Pointedly recognizing "that the right measures are not the same for each of us," the G-8 leaders, at a meeting at Camp David with Mr. Obama as host, committed to "take all necessary steps" to strengthen their economies. They said they wanted to keep Greece in the euro zone and vowed to work to promote growth in Europe, though behind the scenes differences remained about what kinds of stimulus policies to pursue.

"Our imperative," the leaders said in a statement, "is to promote growth and jobs."

It was by no means the final word in the growth-versus-austerity fight, which has been under way for two years. Even with the future of the European currency union in doubt, the German chancellor, Angela Merkel, has insisted that Europe's ailing economies tackle their fiscal problems through spending cuts, among other measures. Critics say the emphasis on austerity has caused higher unemployment, brought Greece to the edge of bankruptcy and worsened the crises in Spain and Italy.

The leaders did yield somewhat to Ms. Merkel's position on austerity, acknowledging that national budget deficits had to be addressed. But they added that spending cuts must "take into account countries' evolving economic conditions and underpin confidence and economy recovery," a recognition of how much the austerity has dampened consumer and political confidence in Europe.

Ms. Merkel and Mr. Obama met privately after the meeting ended. In her public remarks, the German chancellor said that growth and deficit-cutting reinforced each other, and that "we have to work on both paths, and the participants have made that clear, and I think that is great progress."

In recent days Ms. Merkel has signaled that she is open to measures intended to promote economic growth, as long as they do not interfere with long-term efforts to cut deficits in the euro zone. "On the one hand we have the pillar of sound fiscal policy, and the second pillar will then be the growth component," Ms. Merkel said last week in an interview with the cable television channel CNBC.

Also, in a warning to Iran, the leaders pledged to take steps to guarantee continued oil supplies after an oil embargo against Iran begins July 1.

While Greece is not part of the G-8 — the club comprises the United States, France, Germany, Britain, Italy, Canada, Japan and Russia — the political and economic crisis facing Athens hovered over the meeting. Greece has been unable to form a government since

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# European nightmare: Spain and Greece fail

*EURO, FROM PAGE 1*

With Spanish banks now holding deposits of €2.3 trillion, such a loss of confidence could be disastrous for Spain and for the highly interconnected global banking system. The financial world's assumption lately has been that it is sufficiently prepared to absorb the consequences of a Greek withdrawal from the euro. But if a Spanish banking collapse were factored in, Europe's long-dreaded "Lehman moment" might finally arrive. "The scale is just so much bigger, when you talk about Spain," Mr. Deo said.

Technocrats in Brussels will readily say that what is now keeping them up at night is Spain. They are trying to see beyond the tools that so far have kept a the crisis at bay: the two rounds of low-cost loans that the European Central Bank extended to commercial banks late last year and earlier this one, and the €780 billion bailout fund.

One potential new tool, according to Mr. Deo, would be for Europe to guarantee the bank deposits of at-risk countries like Spain. This would be similar to the way the U.S. government increased deposit insurance during the financial crisis in 2008 to head off a bank run. It would be an expensive undertaking, to be sure, and one that would have to be bankrolled largely by parsimonious Germany.

But such a drastic step might steel the shaky nerves of Spanish depositors.

Just such a step was briefly considered by European policy makers last year. But it was shelved on the assumption that North European taxpayers would not be inclined to back the banking system in Spain — or in Italy, whose own banks have still not regained a solid footing, or in other euro zone convalescents.

And without an allocation of new money, there could be no new guarantees for depositors. The total banking deposits in Spain, Italy, Portugal and Ireland are €5.5 trillion, or seven times the size of the main European rescue vehicle, the European Financial Stability Facility.

The other problem is that a deposit guarantee does little good if the citizens of the country in question become convinced that their nation might soon abandon the euro for another currency — as seems to be the case in Greece, where more than €60 billion in deposits have fled banks since the crisis began.

**"When you have Greece and Spain happening at the same time, the problem becomes exponential and very, very dangerous."**

Those account holders fear having euros in the bank that could overnight become drachmas with half the value or less.

So far in Spain, there has been little sign of mass flight of deposits, perhaps, in part, because no one is seriously talking right now about a Spanish exit from the euro. What has been happening, though, Spanish bankers say, is that deposits have been moving from riskier savings banks like Bankia to safer institutions like Santander and BBVA, both of which benefit from having substantial international operations. Bankia is deemed to be so close to the brink that Spain's government has seized control of it.

But there is no question that the Spanish problem with bad loans is growing worse by the month. Last week, official statistics disclosed that nonperforming loans through March were 8.37 percent of the total loans — the highest level since 1994, long before the adoption of the euro.

And it is not only problems in commercial real estate and home-mortgage loans that are mounting. A recent report from Moody's shows that small Spanish businesses — in many ways the backbone of the economy — are also defaulting in increasing numbers, a sign that the Spanish recession is started to feed on itself.

This month the government ordered that Spanish banks increase their reserves against faulty loans to €84 billion.

As the health of the banks that made all these loans — largely the casas, or savings banks — becomes more precarious, so will the danger that depositors big and small will seek the safety of banks outside Spain, with German banks the likely havens.

And if this flight to safety began to take wing just as Europe is confronting the possibility of a Greek exit — or Grexit, to use the crisis shorthand — anxieties about both events could combine to make the market reaction all the worse.

"After a certain point, there is a breaking point," said Mr. Jen, the hedge fund manager.

Investors are now wond ng if this is it.

# G-8 presses Germany to back growth policies and ease calls for austerity

*G-8, FROM PAGE 18*

voters, angry over austerity measures, brought down the last government, and there is now talk of bringing back the drachma and abandoning the euro.

With his own re-election bid tied to a fragile U.S. economic recovery that could easily reverse if the European economy takes another turn for the worse, Mr. Obama was pushing hard Saturday for a euro-zone growth package. U.S. officials said they hoped that after the effort over the weekend at Camp David, Ms. Merkel would be more amenable to the pro-growth argument when she gathers with European leaders this week at a summit meeting to come up with specific steps to fight rising debt while stimulating the economy.

The last time world leaders met to discuss the European debt crisis, in Cannes last November, the French president at the time, Nicolas Sarkozy, joined with Ms. Merkel to push Italy to adhere to an austerity package. But the tone was different this time. Mr. Sarkozy lost his reelection bid to François Hollande, who took office last week promising to focus on growth. And even before they showed up at Camp David to gang up on Ms. Merkel, Mr. Hollande and Mr. Obama had forged a new alliance at a prearranged meeting at the White House to focus on growth.

In comments to reporters afterward, Mr. Obama said that the group needed to discuss ''a responsible approach to fiscal consolidation that is coupled with a strong growth agenda.''

''If a company is forced to cut back in Paris or Madrid, that might mean less business for workers in Pittsburgh or Milwaukee,'' Mr. Obama said to explain why the European crisis mattered to the United States. He said that while Europe's predicament was ''more complicated,'' since it required coordination among multiple governments, steps his own government had taken to blunt the effects of the U.S. financial crisis in 2008 and 2009, including the stimulus, could stand as an example for Europe.

**"If a company is forced to cut back in Paris or Madrid, that might mean less business for workers in Pittsburgh."**

In a tense meeting at Camp David, the presidential retreat, it seemed at times as if it was Ms. Merkel — who faces stiff opposition at home from German taxpayers to more bailouts of the nation's neighbors — against the world. Things did not seem to get off to a good start Friday night, as Mr. Obama greeted his guests for dinner in a rustic wood cabin.

''How've you been?'' Mr. Obama asked Ms. Merkel.

She shrugged and pursed her lips.

''Well, you have a few things on your mind,'' Mr. Obama said consolingly.

Mike Froman, Mr. Obama's top adviser on international economic affairs, was careful not to publicly single out Ms. Merkel and Germany when talking to reporters after the meeting. The debate over austerity versus growth, he said, ''has been going on for some time, and we welcome the evolution on that debate.''

But it remains unclear how far Ms. Merkel will go, despite the pressure from other leaders. Ms. Merkel on Saturday was fresh from a war of words with Greece over that country's continued membership in the euro, with Greek politicians saying that Ms. Merkel had suggested a referendum asking Greece whether it wanted to stay in the euro, a claim that a spokesman for Ms. Merkel denied.

Separately, the leaders also said they were prepared to call on the International Energy Agency to take appropriate action to guarantee oil supplies if prices spiked. ''There have been increasing disruptions in the supply of oil to the global market over the past several months, which pose a substantial risk to global economic growth,'' the group said in a statement.

GUIDO BERGMANN/BUNDESREGIERUNG, VIA AGENCE FRANCE-PRESSE

**Chancellor Angela Merkel met with President Barack Obama at the G-8 summit meeting.**

The oil statement was meant to reassure oil markets that nations would consider tapping into their oil reserves if there were a supply shortage. It was particularly meant to send a warning to Iran — which is the target of an oil embargo to begin July 1 as part of the Western effort to rein in Tehran's nuclear ambitions — that the West would work to counteract high prices for oil when the sanctions took effect. Finally, it was meant to reassure countries like India and China that they would not be hurt by higher prices, once the sanctions began.

Still, U.S. officials expressed optimism that negotiations with Iran over its nuclear program, which are set to reopen at the end of the month in Baghdad, might be productive.

The intimate setting of the meeting — in secluded Camp David, where the leaders slept in cabins and their attendants shared rooms — allowed for a more relaxed atmosphere, White House officials said. Mr. Obama and Prime Minister David Cameron of Britain were exercising on treadmills early Saturday morning while discussing ways to help ease the debt crisis.

''Nobody felt defensive or put on the defense,'' said Mr. Froman, the adviser, disputing reports that Ms. Merkel was isolated.

*Annie Lowrey contributed reporting from Washington.*

# Preserving euro and sovereignty

**Hugo Dixon**

POLITICAL ECONOMY

JOHN KOLESIDIS/REUTERS

**A participant in a strike by bus drivers in Athens. North Europeans fear that integration would force them to bail out southerners.**

What should be the long-term vision for the euro zone? The standard answer is full-fledged fiscal, banking and political union. Many euro zone politicians advocate it. So do those on the outside like David Cameron, the British prime minister, who called on the zone last week to "make up or break up."

The crisis has demonstrated that the current system does not work. But a headlong dive into a United States of Europe would be bad politics and bad economics. An alternative, more attractive vision is to maintain the maximum degree of national sovereignty consistent with a single currency. This is possible provided there are liquidity backstops for solvent governments and banks, debt restructuring for insolvent ones and flexibility for all.

Enthusiasts for greater union think not just that it would prevent future crises but also that it would help solve the current one. The key ideas are that governments should guarantee one another's bonds by issuing so-called euro zone bonds and be prepared to bail out one another's banks. In return, governments and banks should submit to strong centralized discipline over their activities.

But the European people are not remotely ready for such a union. Anti-euro sentiment is on the rise, as evidenced by strong poll showings by candidates like Marine Le Pen in France and Beppe Grillo in Italy. Germany's insistence last December on a fiscal discipline treaty has stoked that sentiment.

An attempt by the region's elite to speed the pace of integration with even more ambitious plans could easily backfire, particularly among Northern Europeans, who would worry that they were being locked into a system in which they would be required permanently to bail out feckless southerners. It might not even help solve the current crisis, as investors would question the creditworthiness of Germany if it had to shoulder the entire region's debts.

A better approach is to adopt the principle of "subsidiarity," which specifies that decisions should be made at the lowest possible level of government that is competent to handle them. This is good politics and good economics. To be fair, even advocates of political union like Wolfgang Schäuble, the German finance minister, subscribe to this principle. The issue is to define the minimum conditions needed for the sustainability of the single currency. There are probably three.

The first is that insolvent entities — whether they are governments or banks — should have their debts restructured. One of the main reasons states and lenders were allowed to leverage themselves so much in the boom was that there was a widespread view that they could not go bust. This sowed the seeds of the crisis.

Meanwhile, a key mistake in managing the crisis was the failure to restructure Greece's debts as soon as they became unbearable. If that had been done, private-sector creditors would have taken the hit. Instead, they were largely bailed out — with the result that 74 percent of Athens's outstanding debt of €274 billion, or $349 billion, is now held by governments and the International Monetary Fund, according to UBS. This means taxpayers will be on the hook when the big fat Greek default occurs.

The second minimum condition for monetary union to flourish follows the first: There should be liquidity backstops for banks and governments that are solvent.

> **Decisions should be made at the lowest possible level of government.**

With banks, the natural liquidity backstop is the European Central Bank. The quid pro quo is that lenders have to be properly capitalized. Time and again throughout the crisis, euro zone governments have ducked this issue. Only this month, France and Germany conspired to dilute the Basel III global capital rules as they apply to Europe, while Spain imposed another half-hearted restructuring on its banks. If the euro zone wants a successful single currency, this nonsense has to stop.

With governments, the natural liquidity backstop is the European Stability Mechanism, the zone's soon-to-be-created bailout fund. To do its job properly, it will need extra funds — as it would not be big enough to help both Spain and Italy. One option could be to allow it to borrow from the E.C.B.

Again, the quid pro quo would be solvency. Insolvent governments would get access only if they restructured their debts. And illiquid but insolvent ones would need credible long-term plans to cut their debts. Italy, with debt exceeding 120 percent of gross domestic product but huge private wealth and state assets, might one day find itself in the latter category.

The final minimum condition for a successful monetary union is much more flexibility, particularly in labor markets. This is the key to restoring competitiveness in Southern Europe and enabling the zone to respond to future shocks.

If the euro zone can do these three things — restructure insolvent institutions' debts, provide liquidity to solvent ones and improve flexibility everywhere — nations will be able to keep the euro and much of their sovereignty. That is a preferable vision to a euro superstate or the chaos of disintegration.

*Hugo Dixon is the founder and editor of Reuters Breakingviews.*

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# G8 leaders back Greece

## *World's most powerful say they want country in euro as Germany holds firm line*

**World leaders** convening in the US presidential retreat in Maryland for the G8 summit of the world's leading industrialized nations expressed conviction over the weekend that action must be taken to keep Greece in the eurozone and curb the financial turmoil shaking global markets as European officials insisted Athens must respect the terms of a debt deal signed with its foreign creditors to safeguard crucial rescue loans.

"We reaffirm our interest in Greece remaining in the eurozone while respecting its commitments," the G8 leaders said in a joint statement, but they did not propose any specific measures for easing the crisis.

The written statement followed expressions of support by individual leaders, notably French President Francois Hollande. Speaking after talks with US President Barack Obama on Saturday, Hollande said, "We share the same views, the fact that Greece must stay in the eurozone and that all of us must do what we can to that effect."

German Finance Minister Wolfgang Schaeuble, whose stance against Greece has hardened in recent months, took a firmer line. In an interview with Kathimerini published yesterday, he said the idea of Greece continuing to receive aid without honoring its commitments was "a pipe dream." His comments echoed those to Germany's tabloid Bild, that "European solidarity isn't a one-way street." Greece's political leaders "are obliged to tell voters that participation in the eurozone is linked to many advantages but also many preconditions," the German minister told Kathimerini. He said Greeks would not just be voting for a party next month but "answering existential questions," an apparent reference to debate about Greece's future in the eurozone.

This issue came sharply into focus late Friday when Greek authorities revealed that German Chancellor Angela Merkel had raised the idea of Greece holding a referendum on euro membership in parallel to elections.

Over the weekend, the chancellor's office continued to deny that Merkel had made such a proposal during her telephone call to President Karolos Papoulias on Friday night. German news magazine Der Spiegel confirmed that the chancellor had broached the idea however, adding that it was floated by Schaeuble at the Ecofin summit last Monday. The intervention prompted angry responses from Greek political leaders.