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Fearing the worst, Europe scrambles

No run on banks yet, but money starts leaving Spain for havens abroad

BY LANDON THOMAS JR. AND RAPHAEL MINDER

Ángel de la Peña, a Spanish civil servant, is seriously considering the once unthinkable: converting his euros to pounds.

And Álvaro Saavedra López, a senior executive for I.B.M. in Spain, says many of his corporate counterparts across Spain are digitally dispatching their spare cash to safer euro zone countries like Germany "on a daily basis."

It is but a trickle so far, these transfers of personal and business deposits from troubled Spanish banks to more secure European havens. Not enough yet to constitute a classic bank panic.

But with European policy makers in Brussels and Frankfurt casting worried eyes toward Madrid, and the ratings agency Standard & Poor's expected to downgrade Spanish banks yet again, economists and finance officials are bracing for the worst: a bank run that would turn into a stampede, with much of Spain's €1 trillion, or $1.25 trillion, in bank deposits leaving the country. The havoc that could cause within the Continent's financial system could threaten the very future of Europe's currency union.

Suddenly, the debt turmoil in Greece, which lately has been Europe's main preoccupation, could be relegated to a regional sideshow.

"A bank run can happen very quickly," said Matt King, an expert on international fund flows in London for Citigroup. "You are fine the night before, but on the morning after it's too late."

In Greece, more than two years into its financial crisis, nearly one-third of the country's bank deposits have already left the country.

There has been no such exodus in Spain, where over the past year about 4.3 percent of bank deposits, or €41 billion, have been transferred out of the country. But that amount is in addition to €140 billion in foreign-owned financial assets, including sales of government bonds, that have left Spain in the past year.

The trend worries European officials. At an informal meeting of European Union leaders Wednesday in Brussels, Italy and some other countries began pushing a proposal to create regionwide deposit-insurance system to buffer account holders against banking collapses. It is especially a concern for Spain, where the national deposit insurance fund is virtually bankrupt.

What is more, the condition of Spanish banks is expected to worsen over the next year as commercial real estate and mortgage losses, a big source of the nation's bank troubles, continue to mount.

So far there is little sign that specific plans for a Europe-wide deposit fund is imminent. But officials in Brussels say the idea, along with the more controversial question of issuing euro bonds backed by the credit of all euro zone members, will be discussed in more detail next month when the European Union leaders hold their next formal meeting.

Such an idea has been around for a long time, but it faces the obvious polit-

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Leaders contemplate the best course if Greece pulls out of euro zone

BY JACK EWING

To listen to European leaders lately, the debate about Greece's exit from the euro zone is increasingly moving from "if" to "how."

Policy makers and many economists continue to regard Greece's departure as a doomsday scenario that must be avoided at all costs, and there is clearly an element of brinkmanship in the talk of a "Grexit." But it has become clear in recent days that secret contingency planning has begun in case events spin out of control.

The German Bundesbank all but acknowledged as much Wednesday when it said in a report that Greece's exit would be difficult, but possible "with careful crisis management." The cautious, data-driven economists at Germany's central bank would not have made that statement without studying the issue thoroughly.

Jean-Claude Juncker, the prime minister of Luxembourg, said early Thursday in Brussels that keeping Greece in the euro zone was still the preferred plan. But he added, "We need to be armed for all eventualities."

No one thinks that amputating Greece from the euro would be easy. And some of the official murmurs about doing so are clearly aimed at Greek voters before the elections next month, which European leaders are trying to cast as a referendum on euro membership.

Still, scenarios for a Greek exit no longer seem like the musings of a few euro-skeptic economists. Even if no one really wants Greece to leave, there is a risk that elections there on June 17 could produce a government that is unwilling or unable to meet terms set by the European Union and International Monetary Fund in return for aid.

Greece would run out of cash by year's end, economists at Citigroup said in a report this week, forcing the country to seek refuge in its own currency.

"As much as policy makers claim this won't and can't happen, there must be

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MARKUS SCHREIBER/AP

FOR MERKEL, A NEW FRONT OPENS AT HOME
Opponents of Angela Merkel, in Berlin on Thursday, are emboldened by shifting political winds on the Continent. *PAGE 3*

HOLLANDE LEADING PUSH FOR GROWTH
The French president has cast himself as the leading proponent of a "new path" to economic recovery in Europe. *PAGE 3*

U.K. RECESSION DEEPER THAN PREDICTED
A continued slump in construction resulted in a deeper first-quarter contraction than expected. *PAGE 18*

Despite disclaimers, leaders are assumed to be preparing for Greek exit

GREECE, FROM PAGE 1

planning going on," said Jennifer McKeown, senior European economist at Capital Economics, a consulting firm in London.

Can a Greek secession be managed?

"I think there is a chance it could be contained," Ms. McKeown said. But she added that she was not confident European leaders would make the right decisions.

As handpicked teams of crack policy makers presumably meet in soundproofed chambers in the bowels of central banks and government ministries to plan for a euro zone Armageddon, they are probably contemplating how to contain two overwhelming risks.

One is that Greece's exit would unleash social chaos in Greece. The other is that it would provoke a financial crisis in the rest of Europe, and perhaps the world, as the collapse of Lehman Brothers did in 2008.

Preparations would need to be prepared in secret, say economists who have studied the issue, then executed with lightning speed over a weekend, when banks were closed.

One serious problem is how Greek officials cou[illegible] new money, which would take we[illegible] months, without word leaking out and provoking a bank run.

Perhaps Greece wouldn't need to print new drachmas right away, economists at Capital Economics argued in a paper this year. Most transactions these days are electronic anyway, they said. For small everyday transactions, Greeks could continue to use the euro until new notes were printed.

Charles B. Blankart, a professor at Humboldt University in Berlin, has argued that Greeks could be allowed to keep their savings in euros during a transition period, to remove the incentive for them to storm the A.T.M. machines in Athens and Salonika.

Greece would also have to contend with the severe devaluation in the value of the new drachma. To some extent, devaluation is the whole point. It would help Greek wages fall in relation to the rest of the world so the country would become competitive in export markets. A weaker currency would achieve the wage cuts, estimated at 40 percent, overnight instead of over years as is likely if Greece stays in the euro.

But there would also be grave side effects. Economists at Citigroup estimate that the new drachma would plunge 60 percent against the euro as soon as currency markets opened. The price of imported oil and other commodities would soar in drachma terms, potentially canceling out the benefits of devaluation.

To prevent hyperinflation, the Greek central bank would need to pursue a tight monetary policy and resist political pressure to print money. The government would also have to become fiscally responsible.

Given Greek political leaders' record so far, that might seem far-fetched. But they might not have a choice. The country could probably not sell debt to foreign investors for years to come, which would require the government to live within its means.

Even in the unlikely event that Greece did everything right, the country would continue to need much international support. Greece's banks would probably collapse. They would need bailouts financed by the European Union.

KOSTAS TSIRONIS/BLOOMBERG NEWS

Euro notes in an ad on a subway train in Athens. Printing drachmas would take weeks.

That means a Greece outside the euro would continue to be a massive financial burden on European taxpayers. But the Union would have an interest in preventing a complete economic collapse in Greece, which could usher in radical leftist or rightist governments or a breakdown in law and order.

That would be only one of the risks to the rest of the Union. To prevent Greece from bringing down the whole continent, Europeans might have to accept measures that are deeply contentious now, like bonds issued by all euro zone countries and backed by all.

So-called euro bonds could be used to take pressure off other vulnerable countries like Portugal and Ireland, to prevent them from being forced out of the euro zone as well.

But during a dinner in Brussels on Wednesday night, in which leaders of each of the 27 countries got their chance to take the floor, a discussion of the euro bond lasted only about 15 minutes, with more countries expressing opposition to the idea than expressed support.

Some analysts argue that an exit by Greece would focus the minds of E.U. leaders and get them to do things they should have done before they created a common currency, like create a powerful pan-European bank regulator and other elements of a federal system.

To prevent bank runs in other countries, European leaders might create a deposit guarantee fund similar to the U.S. Federal Deposit Insurance Corp.

Citigroup economists, who forecast the chances of a Greek exit within two years at 50 percent to 75 percent, said the European Central Bank would also have to move more aggressively.

The E.C.B. would cut the benchmark rate to 0.5 percent from 1 percent, Citigroup said in a report. The E.C.B. would issue more inexpensive three-year loans to commercial banks, like the ones it already issued in December and March.

Given European leaders' tendency to procrastinate, many analysts are skeptical whether they could manage the surgical removal of a euro zone member.

Because of the mind-boggling risks, Jacob Funk Kirkegaard, a research fellow at the Peterson Institute for International Economics in Washington, posits a third scenario.

After electing a populist leftist government, Greece would repudiate the terms of its agreement with the Union and I.M.F., which would then cut off aid. Greece would stop servicing its debt, and its banks would no longer be able to borrow from the E.C.B.

But instead of formally leaving the euro zone, which is uncharted legal ground, Greece would become like Montenegro, using the euro without the benefits of euro zone membership. A few months of the resulting forced austerity, Mr. Kirkegaard said, would be enough to convince the Greek people that they would be better off accepting the conditions imposed by foreign lenders.

"They are going to be Montenegro for a few months, and then they are going to find a way to re-engage with the euro area," Mr. Kirkegaard said. "The chaos that will have happened will serve the political purposes of Germany and others and show the consequences of leaving the euro, which are pretty serious."

Hollande leading in push for growth

PARIS

Eye on next election, e sets agenda that's kely to hit constraints

Y NICOLA CLARK

ince being sworn in as France's presi- ent just 10 days ago, François Hollande ias wasted no time in casting himself as he European leader pushing hardest to forge a growth-oriented "new path" through the euro zone's grinding debt

NEWS ANALYSIS

crisis, pitting himself against the austerity-minded Chancellor Angela Merkel of Germany.

Unstated in this drive, but crucial to it, is that Mr. Hollande's Socialist Party is running hard to secure a victory in parliamentary elections next month, hoping to add the 577-seat National Assembly as the last of the levers of French power it does not already control. (A Socialist-led bloc won an absolute majority the Senate in September, a first since the Fifth Republic was founded in 1958.)

Opinion polls indicate that a Socialist carte blanche may well be within Mr. Hollande's reach. But even armed with such a redoubtable mandate, analysts say, Mr. Hollande would likely face considerable constraints in pressing for some of the solutions he has championed, including the creation of so-called euro bonds jointly guaranteed by all 17 nations that currently share the single currency.

With Greece's exit from the euro club looking more like a real possibility, a new sense of uncertainty is building across the continent as it awaits the judgment of French voters. As it happens, the final vote here on June 17 will coincide, as it did on May 6, with an electoral do-over in Greece, thus setting the stage for the next moves in the attempt to save the euro.

Greece and other wobbly euro-zone countries, such as Spain, are banking on Mr. Hollande to succeed in his pro-growth agenda and to be the point man with Germany for a loosening of the stringent spending cuts and structural reforms that his predecessor, Nicolas Sarkozy, hammered out with Ms. Merkel. But even as a growing anti-austerity backlash sweeps across the currency union, Mr. Hollande's room to maneuver could be far narrower than his euphoric rhetoric of transformation implies.

On Thursday, the Moody's credit ratings agency reminded investors that, despite the change of government, it was maintaining its negative outlook on France's triple-A credit rating. That was based on the nation's high public debt — nearly 90 percent of gross domestic product — and an "overall level of uncertainty regarding the government's ability to achieve its fiscal consolidation and growth targets." (Standard & Poor's, a rival rating agency, already cut France's rating to AA-plus in February.)

France has not had a balanced budget since 1974, and it has one of the highest levels of public spending in Western Europe, at around 55 percent of G.D.P.

Mr. Hollande campaigned on a promise of €20 billion in new spending programs over the next five years that in- cluded vows to increase the minimum vage, hire 60,000 more teachers and re- tore a minimum retirement age of 60 or some manual workers (rolling back increase to age 62 by the Sarkozy vernment). Those measures are ant to be offset by €29 billion in tax in- ases, with an eye to achieving a balanced budget by 2017.

But some of Mr. Hollande's advisers are already hinting that an audit of France's finances scheduled for this summer is likely to reveal a much larger hole in the government accounts than had been acknowledged by his predecessor, Mr. Sarkozy.

"There are certainly deficits, things hidden in the shadows," Mr. Hollande's prime minister, Jean-Marc Ayrault, said recently of the audit. "We will discover the reality and strike a balance between fostering growth and making the necessary efforts to reduce the debt."

Meanwhile, many private economists say that France's official forecasts for future economic growth — 1.7 percent of G.D.P. next year, rising to 2.5 percent after 2013 — are wildly optimistic. France's economy has grown at an average annual clip of 1.6 percent for the past two decades; growth this year is expected to be a meager 1 percent or less.

That could make for a far tighter budget program than Mr. Hollande has been expected to present to an extraordinary session of Parliament in July. Any backtracking on his election promises could well be seized upon by members of the populist National Front, which is expected to win several seats at the expense of Mr. Sarkozy's Union for a Popular Movement — the first time the far right will have been represented in Parliament since the late 1980s.

As if the challenges he faces at home were not enough, Mr. Hollande must also find ways to bridge the left-right divide between European leaders that widened over the last year as Mrs. Merkel and Mr. Sarkozy — a conservative tandem that became known as "Merkozy" — pushed their austerity drive.

Mr. Hollande used the occasion of a six-hour dinner with his 26 other European Union counterparts in Brussels on Wednesday to raise his profile by broaching the controversial subject of euro bonds, an idea that has been fiercely resisted by Berlin. Attendees described the discussion as light on detail, and Mr. Hollande himself conceded that while "there was no conflict, no confrontation between the various countries," some leaders — whom he did not name — "were even more against euro bonds than Mrs. Merkel."

"The relationship with Germany is very important but I am not keeping other countries at a distance."

Even so, Mr. Hollande was determined to reach out to other conservatives. Before heading to the Brussels summit, the French president hosted a meeting in Paris on Wednesday with Spain's center-right prime minister, Mariano Rajoy. At a joint news conference, the two leaders called for a renewed emphasis on stimulating growth and liquidity.

"The relationship with Germany is very important but I am not keeping other countries at a distance," Reuters quoted Mr. Hollande as saying. "I want France to be heard and supported by other countries. I don't want my relationship with Germany to be like an executive board that imposes itself on others."

As if to underscore his new message of frugality, the new French president and his Spanish counterpart boarded a train to the summit, eschewing their presidential jets.

Paul Geitner contributed reporting from Brussels.