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After nearly wrecking monetary union through inaction, bumbling German Chancellor Merkel may have saved the eurozone despite herself.

Angela's *Amateur Hour*

BY KLAUS C. ENGELEN

The endgame for Greece is at hand. Eurozone policymakers appear to accept that the country is insolvent. That acceptance comes "a bit late but not too late," as the *Financial Times* recently summed up the situation in its Lex column.

A year into the crisis and after driving up the bailout costs of taxpayers horrendously, Berlin has won the bail-in of the private sector that it needed in order to calm voters. Whether this will save Greece and monetary union remains uncertain.

Why did it take so long? Last spring, as Greece's problems began to mount, Deutsche Bank CEO Josef Ackermann, who chairs the Institute of International Finance, offered to put together a €30 billion bridge loan on a public-private partnership basis. He and other bankers wanted to secure Greece's external liquidity needs for a year. But the proposal was rejected by German Chancellor Angela Merkel, other EU leaders, and the EU Commission. They thought they could handle any eurozone crisis with public resources, and they ignored the advice of bankers and economists who had experience with Latin America and especially with Argentina's default.

Ackermann's motive behind his proposals and his well-reported trip to Athens was to give eurozone governments enough breathing room to establish something of a European Monetary Fund to cope with Greece and other highly indebted eurozone members in the periphery.

Klaus Engelen is a contributing editor for both Handelsblatt *and* TIE.

Such private-sector involvement at a much earlier stage would have been helpful. It could have contained the Greek sovereign debt virus from spreading to other members. But only as the specter of a breakup of monetary union started to haunt Europe's policymakers was the taboo against including private-sector involvement finally broken. In the run-up to the special EU summit in July 2011, key European leaders called on the IIF and its director Charles Dallara to spell out how leading European financial institutions could contribute toward helping Greece avoid an insolvency. The recommendations of an IIF white paper on Greece are reflected in the central elements of the EU summit's second Greek rescue package (see box).

The special EU summit seems to be an appropriate time to look back at the turbulent Berlin government efforts to have banks and other Greek bond investors share some of the rescue burden.

Many experts concluded that something was deeply wrong with Berlin's euro crisis management.

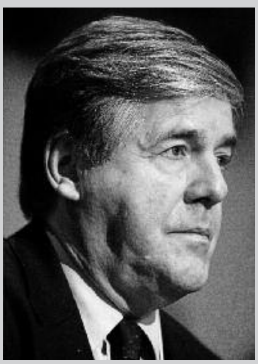
The markets have tested Chancellor Merkel's trial-and-error approach. "Is there an endgame in sight?" was the timely question raised in *TIE*'s Winter 2011 issue, looking at Germany's role in the dismal management of the eurozone's sovereign debt crisis and how much could be attributed to Merkel's governing style. Merkel has stuck to a short-term, politically low-cost strategy, trying to maintain or gain political power while making a minimum of political enemies. After all, she is a "power frau," and indeed for many years her approach has been quite successful.

In the effort to involve the private sector, Germany—as the financially strongest member of the eurozone—has been supported by other creditor countries such as the Netherlands, Austria, and Finland. This "northern" creditor bloc, however, has been facing increasing opposition the farther south one looks. In Italy, Spain, and Portugal, the calls for eurobonds, larger rescue facilities, and lower support interest rates have been getting louder. While Belgium, with a precariously high sovereign debt but unable to form government, has stayed on the sideline, France, fearing that it also might be contaminated, has been warming up to the idea of private-sector involvement. With the crisis reaching a breaking point, certain questions arise. What did the German effort to push for burden-sharing so far achieve? What have been the consequences for market and risk premiums, and the impact on total bailout costs for taxpayers in creditor countries?

With Italy and also Spain now confronting escalating risk premiums and bond selling pressures from an eroding eurozone investor base of banks, insurance concerns, and other institutional investors, the European debt crisis has entered a new and far more costly phase.

There isn't a bailout big enough to rescue the third-largest economy in the eurozone the way there was with Greece, Ireland, and Portugal. Italy can only rescue itself. With a gross debt-

Missed Opportunity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Josef Ackermann

When Deutsche Bank CEO Josef Ackermann, Germany's most successful but controversial banker, started early last year to put together a large private-public syndication of about €30 billion to cover Greece's rollover needs for 2010, Merkel and her then-chief economic advisor Jens Weidmann rejected this idea. Ackermann's plan was a bridge loan given to Greece through the state-owned KfW Group, backed half by loan commitments from leading banks without guarantees and half by public loans from eurozone governments. What the Merkel chancellery and the Schäuble finance ministry missed was that such a liquidity bridge loan would have given Berlin and other eurozone governments some time to come up with a new financing framework for Greece and other over-indebted eurozone countries.

—*K. Engelen*

Ackermann's Banker War Room

On the final stretch of the second Greek bailout, a small group of top executives from Europe's banking and finance sector negotiated the terms and size of the industry's "voluntary" contribution from what they called a "banker war room" at the European Council building.

What eventually found its way into the EC special summit's second Greek rescue package as a private-sector debt relief contribution started in Rome, Italy, on June 30. On that day, Italy's Finance Secretary Vittorio Grilli invited a group of bankers to the Italian Treasury to sort out a "private-sector involvement" urgently needed to complement the bailout.

Speaking informally on behalf of other finance ministry colleagues, Grilli confronted the bankers with a €30 billion burden-sharing demand from the public sector. Banks, insurance firms, and other major Greek bond investors should also come up with their share. In a first and historic call from European governments for the help and expertise of the most important global finance industry association, the Washington-based Institute of International Finance, IIF Director Charles Dallara was also invited. (Deutsche Bank CEO Josef Ackermann for years has chaired the IIF.) Also present was Allianz SE finance head Paul Achleitner, who had recently proposed a voluntary swap of Greek bonds by setting up a European monoline insurer for sovereign debt.

With European central bankers fighting any debt rescheduling plan for Greece—even if it were voluntary—Grilli's talks with the banks stalled for about two weeks while an expert group at the IIF drafted a white paper spelling out possible debt relief options.

"Things can't go on this way much longer," exploded Ackermann when he met Eurogroup President Jean-Claude Juncker on July 14, at a time when the crisis had further escalated. Ackermann's plea to Juncker was for governments and bankers to start talking and cooperating before the markets went haywire.

Meanwhile, Grilli had been sorting out possible modalities of a private-sector contribution with Berlin's Finance Secretary Jörg Asmussen and others.

During the weekend of July 16–17, it became clear that the situation had deteriorated so much that there would be no way out of the crisis without getting banks and insurance companies on board. But efforts by Juncker to organize a meeting of key bankers with German Finance Minister Wolfgang Schäuble and French Finance Minister François Baroin failed.

At last, on July 20, French President Nicolas Sarkozy on his last-minute visit to German Chancellor Angela Merkel failed to get German backing for his alternative plan of a banking levy to avoid debt rescheduling. Thus, it was Merkel who eventually gave the green light for the "war room" proposals of the bankers. That was in essence a four-option private-sector debt relief package—with three forms of debt exchange and one roll-over plan—leading to a 20 percent net present value debt relief on Greek bond holdings.

—K. Engelen

Charles Dallara *of the Institute of International Finance: Behind-the-scenes chess master?*

to-GDP ratio of 120 percent, Italy owes about one-quarter of all government debt in the eurozone.

When Berlin insiders talk of an "endgame" in the context of how Merkel, Finance Minister Wolfgang Schäuble, and company have responded to the eurozone debt, they could summarize the zigzagging journey under the heading: "How a strategy of minimal political costs since February of last year led to self-entrapment, leaving Berlin policymakers with only extremely costly options."

When asked in one of the recent traditional summer interviews about her plans for resolving the escalating crisis, Merkel answered that she "only does what is necessary." This explains why she avoided from the beginning investing too much of her own political capital, but instead looked for opportunities to maintain and strengthen her domestic political power.

Let's follow Merkel's politically low-cost journey step by step. When Deutsche Bank CEO Josef Ackermann, Germany's most successful but controversial banker, started early last year to put together a large private-public syndication of about €30 billion to cover Greece's rollover needs for 2010, Merkel and her then-chief economic advisor Jens Weidmann rejected the idea. Ackermann's plan was a bridge loan given to Greece through the state-owned KfW Group, backed half by loan commitments from leading banks without guarantees and half by public loans from eurozone governments. What the Merkel

Merkel will have to tell German voters that in order to save the monetary union, she will need further billions in German guarantee pledges, credit enhancements, and euro infusions, thereby commiting ever-larger portions of German tax revenues for years to come.

chancellery and the Schäuble finance ministry missed was that such a liquidity bridge loan would have given Berlin and other eurozone governments some time to come up with a new financing framework for Greece and other over-indebted eurozone countries. Why did the Berlin government not take up the Ackermann offer? For Merkel, taking into consideration the elections in North Rhine-Westphalia (her party lost), even a $15 billion liquidity loan from major eurozone countries was considered inopportune.

It would have made a big difference if, at that early stage, the Berlin and Paris governments had brought in the Institute of International Finance through Ackermann and other top CEOs of other European banks. With about four hundred major international banks and other financial service institutions as members, the IIF, chaired by Ackermann, has a long history of dealing with sovereign debt issues. Late, but maybe not too late, EU finance ministers are finally working together on the issue of private-sector involvement in crisis resolution. Under the leadership of IIF Managing Director Charles Dallara, a task force on Greece with experts from major banks produced a white paper that was presented to EU leaders and finance ministers on July 9 of this year.

Following her politically low-cost strategy, Merkel let the Greek fires smolder for critical weeks without reaching a political agreement that would calm alarmed bond investors when Greece lost its access to the capital markets. Eventually, in May 2010, Merkel did what she had to do and consented to a huge support mechanism for Greece worth about €110 billion, including loans from the International Monetary Fund for about one-third of the credit support. And days later Merkel again did what she had to do when EU leaders stood up against the "wolfpack" of international speculators and put together a €750 billion mega-safety net to help eurozone member countries in case they lost financing access to the markets. They established the Luxembourg-based European Financial Stability Facility with a headline figure of €440 billion ($600 billion), which became useful in rescuing Ireland and Portugal from insolvency.

After having pushed these huge financial pledges for Greece and the temporary rescue facility EFSF through the Bundestag, Merkel wanted to make sure to soften the blow to her party and the broader electorate by coming up with measures to repair some of the lost equity.

"She Is Wrecking My Europe"

Helmut Kohl

The man who brought Angela Merkel as a young East German physicist into the Christian Democratic Party leadership, former chancellor Helmut Kohl, isn't holding back his worries. After the recent shock from Italy, *Der Spiegel* reported how the deepening frustration with Merkel's CDU has also reached the elder statesman. Kohl, who played a key part in establishing European monetary union, is sharply critical of Merkel's "risky" European crisis management. "She is wrecking my Europe," Kohl is reported to have confided to friends, who visited the gravely ill former chancellor in his house.

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There was the nagging question of bankers again making big money after taxpayers had bailed out their banks. And there was the chance to do something about it by introducing the issue of letting bondholders share some of the financial burden.

But last fall, Merkel and Schäuble misread the fragile market conditions—an eroding investor base for peripheral bonds and a lot of risk aversion—and Berlin's haircut proposals turned out to be a costly policy error, injecting new uncertainty into bond markets. Risk premiums for Greece and other financially weak sovereign debtors reached record levels, causing even higher interest costs and making the whole rescue effort much more expensive to taxpayers. Many experts concluded that something was deeply wrong with Berlin's euro crisis management. Some political observers, however, made the point that having private-sector involvement mentioned in the media was what counted, not whether that involvement was actually achieved. When proposing the permanent European Stability Mechanism with detailed "modalities for involving the private sector" by mid-2013, there might have been the assumption that in two years the acute eurozone debt crisis would be over. That won't be the case.

After Merkel and Schäuble failed dismally last year to "bail-in" the private sector, Schäuble didn't get far this year at first with enticing banks and insurance companies to contribute to the second Greek rescue package by rolling over maturing Greek bonds on a "voluntary" basis. As top euro crisis fighter, Schäuble got a lot of media attention with his bond rollover proposals. For months he insisted that any new aid package for debt-stricken Greece must involve banks and other investors.

The European debt crisis has entered a new and far more costly phase.

He hoped, by getting banks, insurance companies, and investment funds to roll over Greek bonds with long maturities, to raise about €30 billion for a second Greek bailout, which could be in the range of €120 billion.

In announcing his plan, he met with fierce resistance from many eurozone countries, but also opposition from the European Central Bank and the Bundesbank, as well as warnings from the rating agencies. The ECB indicated that even if banks agreed to roll over maturing Greek bonds on a voluntary basis, this could lead the rating agencies to judge this a "credit event" with the consequence that the ECB would cease to provide liquidity to Greek banks. When the rating agency Fitch downgraded Greek debt to one step above default status, they listed "the lack of certainty on a second aid package for Greece" as a reason. "Schäuble is backing down" read the headline in the July 14 issue of *Handelsblatt,* Germany's economic and financial daily, as it looked like private creditors wouldn't contribute to the new aid package for Greece—a big defeat for Germany.

Those steps led Merkel and Schäuble to the present situation, with only extremely costly options left. Merkel will have to tell German voters that in order to save the monetary union, she will need further billions in German guarantee pledges, credit enhancements, and euro infusions, thereby committing ever-larger portions of German tax revenues for years to come.

There is a pervasive unease about the way Merkel and Schäuble have been handling the eurozone debt crisis—for many reasons.

For too long, calls for rescheduling Greek debt were taboo, as happened in the Latin American debt crisis before the so-called "Brady Plan" made it possible to reduce the countries' debt burden by exchanging non-performing outstanding loans at a discount with new tradable bonds.

So far, Germany's political elite has not been able to calm the public's worries about the stability of their money and the future cohesion of monetary union. Seeing violent protests in Greece, Spain, or Portugal every day on television is eroding confidence. Months of bickering between the German government and the European Central Bank over

Larry Summers on Merkel

In what amounted to an outright condemnation of Merkel's actions in the escalating euro crisis, Larry Summers, the key architect of the bank rescue in the United States, fully backed Frankfurt's central bankers: "The European Central Bank is right in its concern that punishing creditors for the sake of teaching lessons or building political support is reckless in a system that depends on confidence."

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Larry Summers

possible bond rescheduling and bond rollovers hasn't helped, either. EU coordination and crisis management has been so bad that some consider it a systemic risk. Ultimately, Europe as a whole faces a leadership crisis.

CALLS FOR GREEK DEBT CUTS GOT LOUDER

With the "Greek virus" reaching Italy and Spain and risk premiums escalating, economists and politicians began calling with more urgency for cutting Greek debt through various means—rescheduling, haircuts, debt forgiveness, and bond buybacks on secondary markets. For the opposition Social Democratic Party leadership, a Greek debt rescheduling was no longer taboo due to the realization that Greece was insolvent, and could only get back on its economic feet again if its sovereign debt burden of 160 percent of GDP was halved so that access to capital markets was regained.

Martin Blessing, CEO of Commerzbank AG, Germany's second-largest private bank, was the first German commercial bank chief to come out for a Greek bond rescheduling, as he discussed in an interview with the daily *Die Welt.* Blessing suggested a rescheduling with discounts from face value of about 30 percent. Since Commerzbank is still operating with government support from the Financial Market Stabilization Fund, Blessing's call for a Greek debt rescheduling was seen to have political backing from high places.

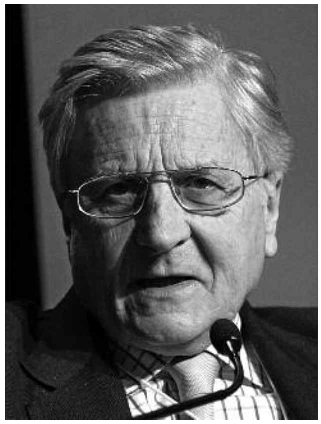
Beatrice Weder di Mauro, a member of Germany's Council of Economic Experts, who specializes in the analysis of banking and financial markets, called for a speedy Greek debt rescheduling, followed later by debt rescheduling for Ireland and Portugal, in an interview with *Handelsblatt.* "The question we face now is whether Europe breaks up," she warned.

As EU leaders prepared for a special summit on July 21 to overcome longstanding divisions on a second rescue plan for Greece and to decide on adjustments in size and flexibility to the EU bailout fund, the EFSF, Merkel and Schäuble came under massive pressure tell the public what they were up to and calm the markets.

GERMAN ANGST ABOUT THE EURO

As the German public grew more alarmed about the escalating euro crisis, no wonder that Berlin's ruling conservative-liberal coalition began sinking in the opinion polls. The specter of German taxpayers footing the bill for ever-more bailout billions for Greece and other highly indebted eurozone countries is haunting important segments of the German electorate. Even within Merkel's governing coalition, some Bundestag members have been very critical of any new bailout schemes. Simple calculations by leading economists in the endless debates about the crisis have been sinking in. The head of the Munich IFO Institute, Hans-Werner Sinn, argues that since 2008, Greece has been financing public and private consumption that is 17 percent greater than what it generates in goods and services, simply through more debt or money from the printing presses. German and EU leaders confront the simple choice of whether to use taxpayer money and capital to allow the Greeks to continue like this.

ECB President Jean-Claude Trichet *did not shy away from risking open conflict with Sarkozy and Merkel in defense of the independence of the ECB.*



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The threat of Germany sliding further into a "transfer union" has undermined confidence, especially in the conservative and liberal parties that form the ruling coalition government under Merkel. The recent hearing of the complainants against the bailouts before the German Constitutional Court in Karlsruhe demonstrated how much the Berlin government is acting within considerable constraints. The Merkel government is under close observation by the constitutional judges.

Opinion polls reflect the fallout from the Greek sovereign debt virus spreading to Italy, the core of monetary union: 86 percent of Germans are worried about the stability of the euro according to the recent "ZDF-Politbarometer." The crisis heads the list of concerns of the average German citizen (33 percent), topping the

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worry about unemployment (22 percent) and the national debt and nuclear threats (both with 11 percent).

So far, the European solidarity orientation of the major opposition parties—the Social Democrats and the Green Party that is almost catching up to the Social Democrats in recent elections—has kept party leaders from using the growing fear about the future of the euro in populist attacks on the ruling coalition. They support the European Union's rescue efforts for Greece, Ireland, and Portugal, and in principle support the new permanent European Stability Mechanism that is supposed to come into effect by mid-2013.

But under a young member of the Bundestag, Frank Schäffler, an anti-bailout faction has been gathering strength in the Free Democrat coalition party, supported by some euro-skeptic parliamentarians in both the ruling conservative Christian parties.

The man who brought Merkel as a young East German physicist into the Christian Democratic Party leadership, former chancellor Helmut Kohl, isn't holding back his worries. After the recent shock from Italy, *Der Spiegel* reported how the deepening frustration with Merkel's CDU has also reached the elder statesman. Kohl, who played a key part in establishing European monetary union, is sharply critical of Merkel's "risky" European crisis management. "She is wrecking my Europe," Kohl is reported to have confided to friends, who visited the gravely ill former chancellor in his house.

BERLIN ON A COLLISION COURSE WITH ECB

And then there has been the nerve-wrecking public war between Merkel and Schäuble on one side and Jean-Claude Trichet, the outgoing president of the European Central Bank, on the other.

The conflict started after Merkel and French President Nicolas Sarkozy took their historic walk on the beach of the French seaside resort of Deauville in October of last year and decided to set up what became the ESM in order to force the private sector to share some of the rescue burdens in sovereign eurozone insolvencies by taking haircuts, extending maturities, or lowering interest rates.

Ever since the EU summit in May 2010, where he presented European leaders with a horror scenario of ever-greater speculative waves against highly indebted and fiscally weaker eurozone countries, Trichet remained stubbornly against rescheduling and haircuts on sovereign eurozone debt instruments. No wonder that Trichet's designated successor, the Bank of Italy's Mario Draghi, sided with Trichet and supported the ECB position against letting Greek bonds be subject to rollovers and thus risking a selective default verdict by the rating agencies. Jens Weidmann, the long-time chief economic advisor to Chancellor Merkel who took over the presidency of the Bundesbank recently from Axel Weber, came out strongly in support of Trichet and the ECB Council against debt rescheduling for eurozone members. Weidmann has also rejected the issuance of eurobonds. Such a move would have far-reaching consequences, since German taxpayers would then be liable for the whole of Greek debt.

The ECB resisted even accepting as collateral Greek bank bonds, in case such bonds were subject to "voluntary roll-overs" by the banks in the context of private-sector burden sharing.

For months, however, against strong resistance, particularly from the rating agencies, Schäuble continued to insist that any new aid package for debt-stricken Greece must involve banks and other private investors.

When this chapter is written for the history books, perhaps titled, "How the European Monetary Union Broke Up," the record will show that Trichet did not shy away from risking open conflict with Sarkozy and Merkel in defense of the independence of the ECB. And this open conflict might be seen as a defining moment for the monetary stability of the eurozone.

Trichet, who for many years chaired the so-called "Paris Club," the forum where governments reschedule non-performing loans to developing countries, has experienced countless sovereign debt crises and knows how markets function. Trichet and his ECB Council have responded to the eurozone sovereign debt troubles by allowing a large portion of the bailout financing to be provided by Europe's central banks in an effort to give European leaders and governments time to establish new institutional frameworks for dealing with liquidity-strapped and insolvent members. The ECB's credibility,

The EU Leaders' Euro Rescue Plan

The €440 billion ($633 billion) temporary bailout fund, the European Financial Stability Facility, gets new powers: to provide funds to recapitalize banks, to make short-term loans, and in "exceptional circumstances" even buy back bonds of over-indebted eurozone states. The EFSF is allowed to act preemptively to help eurozone countries that are not under a rescue program but face temporary difficulties in raising debt. This could be Spain or Italy.

To lessen the debt burden of Greece, Ireland, and Portugal, interest charges for EFSF loans will be extended from seven and one-half years to at least fifteen years with interest rates lowered to about 3.5 percent.

At the center of the EU rescue plan is the participation of banks and insurance companies in the rescue, strictly limited to Greece. A key element is a proposal for bond swaps for all Greek government debt falling due for repayment up to the end of 2019. This would cause the credit rating agencies to come up with a "selective default" announcement. Bondholders will have a choice of four options—three bond exchanges and one rollover plan. On average, investors would take a 21 percent loss in the net present value of their current holdings. A variety of credit enhancements to provide an incentive are under discussion.

The Institute of International Finance, which put the plan together, has signed up support from thirty leading investors including BNP Paribas and Société Générale in France and Germany's Deutsche Bank and the insurer Allianz. The IIF said it was expecting a participation rate in the program of 90 percent, which would contribute €54 billion between mid-2011 and mid-2014, and a total of €135 billion during the period to 2020. According to the IIF, their participation will extend the maturity profile of Greek debt from six to eleven years. But EU leaders put the private sector contribution much lower, at €37 billion for 2011–14 and €106 billion for the whole of 2011–19.

—K. Engelen

however, reached new lows for taking in billions in toxic sovereign bonds from the eurozone periphery.

Trichet sharpened his tone in the run-up to the special EU summit in July, warning governments against letting Greece default. "If a country defaults, we will no longer be able to accept its defaulted government bonds as normal eligible collateral," Trichet told the *Financial Times Deutschland.*

It is difficult to judge the impact on the broader German public of the rift between the Merkel government and Trichet's ECB. For a generation of Germans characterized by former EC President Jacques Delors with the words: "Not all Germans believe in God, but they all believe in the Bundesbank," the ongoing fight between the ECB and Berlin on the issue of private-sector involvement has been definitely unsettling. Traditionally, most savers and investors take the side of central bankers in the case of public disputes because they see them as guardians of secure the value of their money.

This time may be different, since the bones of contention—such as the impact of rating actions on so-called distressed bond exchanges—are complex issues and difficult to understand. But most taxpayers agreed with Merkel that the banks and other bond investors should assume part of the rescue burden for highly indebted eurozone members. There was suspicion that Trichet and new Bundesbank President Jens Weidmann rejected any kind of debt rescheduling in order to avoid losses on their bond portfolio. They may have been "talking their book"—worried that central banks would suffer similar losses as banks, insurance companies, or pension funds by writing down bond holdings of strained sovereign debtors.

EUROZONE CRISIS MANAGEMENT: A SOURCE OF SYSTEMIC RISK

No wonder that EU policymakers—in particular the so-called "Eurogroup" of eurozone finance ministers (where German Finance Minister Schäuble plays a key role)—have come under attack from many sides for the lack of leadership in Europe.

Recently they got what *The Economist* called "a stern wigging" from George Papandreou, the Greek prime minister. Drawing attention to the fact that his country had done its part by pushing through extremely painful economic reforms, he condemned the "indecisiveness and errors" of the European response to the crisis, noting that "a cacophony of voices and views" had prevailed, "creating more panic than security."

And from the other side of the Atlantic, former U.S. Treasury Secretary Larry Summers reminded European leaders in the *Financial Times* that recent "drama over bond auctions in Europe's third-leading economy should convince even the most hardened bureaucrat that the world can no longer let policy responses be shaped by dogma, bureaucratic agenda, and expediency" and that "the world can no longer afford the deference that the International Monetary Fund and non-European G20 officials have shown European policymakers in the past fifteen months." In what amounted to an outright condemnation of Merkel's actions in the escalating euro crisis, the key architect of the bank rescue in the United States fully backed Frankfurt's central bankers: "The European Central Bank is right in its concern that punishing creditors for the sake of teaching lessons or building political support is reckless in a system that depends on confidence."

The IMF, a key aid provider in the eurozone rescue operations, was highly critical of EU leaders who couldn't get their act together. Almost totally ignored by the European media and political class, the IMF staff's "Concluding Statement of the IMF Mission on Euro-Area Policies" under the 2011 Article IV consultation discussions (posted June 20, 2011) bluntly addressed the dismal failures in eurozone crisis management, hitting hard at the major culprits—the Germans with Merkel and Schäuble, who played hardball when it came to providing ever-more bailout billions for highly indebted euro member countries suffering under ever-higher risk premiums pushing up interest rate costs and strangling economic growth and employment.

Condemned a year ago as "Europe's biggest coordination failure in modern history," the EU response has caused damages almost beyond comprehension. The disregard of European leaders for economic and market realities has become a systemic area risk. Politicians and EU bureaucrats have been kicking the can down the road, thereby risking that the ECB will become the eurozone's "bad bank."

Merkel has at last faced market realities.

"The Greek crisis is fast descending into farce," wrote columnist Hugo Dixon of Reuters. He continues: "The position of Germany, the eurozone's main lender, is increasingly absurd. It is adamant that there will be no restructuring of Greek debt—at least, until 2013. And yet it is equally insistent that Athens' private-sector creditors should contribute up to €30 billion to a new, €120 billion bailout. That would effectively amount to a half-cocked restructuring." Admits Dixon: Merkel's "conflicting demands are becoming virtually impossible to reconcile."

Articles in *TIE* have covered Merkel and Schäuble's dazzling inconsistencies since the start of the Greek tragedy at the beginning of last year. (See "The Death of the (German) Euro," Spring 2010; "Gunfight at the ECB Corral," Fall 2010; and "Angela Merkel's Nightmare," Winter 2011.) To make a long story short, in spite of several major private-sector involvement initiatives, up to the special Brussels EU summit, Merkel and Schäuble failed dismally to get private-sector investors to share some rescue burden. The flow of media headlines may have given the German electorate the impression that Merkel and Schäuble have been standing up to greedy bankers and speculators. In that respect, Merkel's push for greater private-sector involvement in crisis resolution was more part of a reelection campaign than changing the rules of the game in euro bond markets. And for Merkel, getting political mileage is what counts. Heading into the Brussels summit, "Berlin's inattention in this crisis has put the burden of rescuing the euro on Europe's taxpayers—surely an unintended consequence," concludes the *Financial Times* in its Lex Column under the heading "Eurodämmerung."

By pushing through her long-standing demand for the finance industry to share some of the Greek rescue burden and by giving up Germany's strong objections to widening the lending activities of the EFSF, Merkel has at last faced market realities. After nearly wrecking monetary union by sitting things out, she now can claim a sort of victory at home and on the European stage, even though the introduction of the private sector into the Greek rescue means the first default of a eurozone member country. This happening even for a short time might have grave market and regulatory implications and push up interest costs. Since the major opposition parties Merkel faces—the Social Democrats and the Green Party—are supporting her steps in the direction of more common European fiscal solidarity and liability to keep European Union together, she might have gained politically at a time when she and her party have been falling in the polls. Berlin's agreement to widen the range of instruments of the European bailout fund might yet set the EFSF on the road to evolving into a sort of European Monetary Fund with conditional lending and bank rescue capabilities. Facing an electorate that fears that Germany in its role as Europe's paymaster is overextending itself by rescuing Greece and the eurozone periphery, Merkel will argue that in Brussels she at least avoided a full-fledged plan for issuing eurobonds to save monetary union. ◆