Angela Merkel's *Nightmare*

The markets test the German Chancellor's approach of trial-and-error. Is there an end game in sight?

BY KLAUS C. ENGELEN

As we go to press, German Chancellor Angela Merkel continues to display her characteristic political technique, a mixture of trial-and-error with "unilateral instincts," plus a hefty dose of *nicht regieren,* or non-governing. But sitting things out in a globalized world while managing the largest European economy in times of crisis can be damaging and very costly. This year, she faces seven state elections. There is a lawmaker revolt over pledges to defend the euro by providing more rescue financing, especially among the ranks of her weakened coalition partner, the liberal Free Democratic Party. Making matters worse, the newest opinion polls show that more than four out of five Germans oppose increasing the bail-out fund for the euro. Add to that the jolt that Bundesbank head Axel Weber, the German frontrunner to head the European Central Bank, has withdrawn his candidacy by announcing that he would not serve a second term as Bundesbank president.

Merkel has experienced a rapidly changing political environment since the eurozone crisis started early last year with the threatened default of Greece. She seems to realize that important segments of Germany's elite and a large part of the general population no longer want to serve as Europe's paymaster without more say in what is done with their money. Ill-feeling is growing against an ever-more-encroaching bureaucracy in Brussels telling Germany what to do. And there is resentment that the so-called "Club Med" countries along with a banking and corporate tax haven like Ireland now expect to be bailed out with German money on the grounds of European solidarity. Germans worry that their trusted Bundesbank is being taken over by

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Club Med central bankers who are ganging together to soften the euro.

As the international pressures mount on Berlin to do more to solve the euro crisis, Germany and France seem to be moving closer together, with not one but two odd couples: French President Nicolas Sarkozy and Merkel, and also their finance ministers, Christine Lagarde and Wolfgang Schäuble. Lagarde is a renowned global corporate and banking lawyer by profession, and Schäuble was former Chancellor Kohl's point man in organizing German reunification. The German-French cooperation comes from economic and financial necessity. Sarkozy has strong incentives to keep Merkel on his side, such as the high exposure of French banks in Greece and other peripheral eurozone economies, France's failure to keep up economically with global export machine Germany, the specter of a lost decade for *la Grande Nation,* and fear that France may soon lose its triple-A bond rating.

UNDER ATTACK FROM THE EU BIGGIES

Since late last year, ECB President Jean-Claude Trichet has called for a substantial increase in "quantity and quality" of the Luxemburg-based European Financial Stability Facility established in May last year. Its headline figure is €440 billion ($600 billion), but due to cash buffers and a guarantee cap, its lending capacity so far is only around €250 billion. In the meantime, EU finance ministers decided that the European Stability Mechanism, which will replace the present EFSF after 2013, will have a lending capacity of €500 billion ($675 billion).

The European Central Bank wants to rescue the euro by doling out easy money in order to keep weak eurozone sovereigns and banks with zero or reduced market access afloat. Trichet and his colleagues are eager to transfer much of the rescue job to where it belongs: the governments and their fiscal resources.

Under what was intended as a stopgap measure in May of last year, the European Central Bank has bought through its Securities Market Programme €76.5 billion worth of sovereign bonds of countries such as Greece, Ireland, and Portugal in an effort to keep down their borrowing costs. This much-debated program came on top of €60 billion purchased in the form of

Fear is growing that the trusted Bundesbank is being taken over by Club Med central bankers.

The Odd Couples

Nicolas Sarkozy and Angela Merkel

Wolfgang Schäuble and Christine Lagarde

As the international pressures mount on Berlin to do more to solve the euro crisis, Germany and France seem to be moving closer together, with not one but two odd couples: French President Nicolas Sarkozy and Merkel, and also their finance ministers, Christine Lagarde and Wolfgang Schäuble. Lagarde is a renowned global corporate and banking lawyer by profession, and Schäuble was former Chancellor Kohl's point man in organizing German reunification.

—*K. Engelen*

ARMIN KÜBELBECK

Merkel's Fear of Brussels

Observing the way Chancellor Angela Merkel governs through the crisis brings us to Merkel's biographer, Gerd Langguth, a political science professor at Bonn University. Asked what characterizes Merkel's governing style, Langguth told Bloomberg's Tony Czuczka and Simon Kennedy, "It's policy by trial and error. She passionately takes a position, then she turns 180 degrees and changes her mind. She doesn't do politics from the gut. Sure, therein lays a danger, because those politicians often have a feel for getting it right. Merkel just wants all facts on the table."

And Merkel's "unilateral instincts"? In a recent issue of *International Politics and Society,* Melanie Morisse-Schilbach, a political science professor, argues, "Germany, having finally decided to act, did it mainly unilaterally…."

Pointing to Merkel's decision to invite the International Monetary Fund into the Greek rescue operation, Morisse-Schilbach concluded: "The fact that Germany preferred to see the Greek crisis solved by the IMF rather than by the European Monetary Union might be an indication that the German government, indeed, mistrusts the EMU's institutional settings and does not believe in the power of EU institutions to solve the problem…."

In her view, "[T]he consequences of this strategy of non-commitment and unilateralism might be severe, for both the system and Germany: all actions, decided on under domestic political (regional elections in North Rhine-Westphalia) and legal pressure (the German Constitutional Court's decision on Europe and the Lisbon Treaty) have—according to first assessments—contributed significantly to increasing the crisis of the markets and deepening a confidence and solidarity crisis among the EU member states…. When Germany agreed to contribute to a bailout fund, Europe's economic problems were far worse, and Germany and others committed themselves to paying much more, if needed. Merkel delayed a financial rescue for Greece until the contagion began to spread to other countries, especially Spain and Portugal. In fact, Germany's reluctance and caution over a bailout for Greece helped to turn a Greek debt crisis into one that threatened to destabilize the entire Eurozone."

—K. Engelen

implicitly government-guaranteed covered bonds between July 2009 and June 2010.

Based on ECB data, Deutsche Bank Global Market Research computes ECB net lending to banks in peripheral countries as of December 2010 at stunning levels. The ECB's net lending to Greece reached €97.8 billion, or 37 percent of the country's GDP. The net lending figures for Ireland: €94.6 billion, or 68 percent of GDP; for Portugal, €42 billion, or 24 percent GDP, for Spain, €61.6 billion, or 4 percent of GDP. Additional liquidity is provided by individual central banks of the Eurosystem against relaxed or zero collateral requirements. According the latest figures, at the end of 2010, banks in Portugal, Ireland, Greece, and Spain had obtained €300 billion in liquidity through their national central banks. This means that one-quarter of the eurozone banks obtained three-quarters of the total liquidity provided through the ECB system.

This high exposure in the financially weak eurozone countries makes clear that the European Central Bank is moving further towards becoming Europe's "bad bank," thereby damaging its independence. Jean-Claude Juncker, prime minister of Luxembourg and an old friend of the governing German Christian Democrats, has become a sharp critic of Merkel's response to the crisis and has lost his traditional position as mediator, especially between France and Germany. Merkel and Schäuble had made clear that Germany would not accept—with exception of backing bonds issued by the EFSF—a broader scheme of community-guaranteed bond issuance. In spite of this, Juncker, together with Italy's economic and finance minister Giulio Tremonti, came up with an ambitious plan for "eurobonds" guaranteed by EU community member states. For Germany, the eurozone's largest creditor, this was a political provocation. Juncker and Tremonti urged the establishment of a European Debt Agency with a mandate to gradually issue outstanding community debt equal to 40 percent of the GDP of the European Union and of each member state. When Berlin sharply rejected Juncker's idea, Juncker accused Merkel of "un-European behavior" and "simplistic thinking."

EU Commission President José Manuel Barroso, the former conservative prime minister of Portugal, whom Merkel had helped to get his Brussels job, stood up against Merkel by insisting on a speedy expansion of the European rescue facility and supporting the introduction of eurobonds. His action damaged further an already strained relationship. The news magazine *Der Spiegel* ran an article titled: "Waning Influence in Brussels: Euro Crisis Leaves Germany Increasingly Isolated." So Merkel is under pressure from all sides.

FIGHTING BACK BY ASKING FOR MORE

What does an fifty-six-year-old scientist who grew up in communist East Germany do to get out of this corner?

Holding on to power is what Merkel knows best. After a period of sitting, she moves forward with a new agenda to dominate the media and catch the attention of voters.

Merkel is treading a fine line as she seeks to balance her solemn pledge to save the euro with the increasing worries in her governing coalition about the escalating resentment of taxpayers against beefing up the "rescue umbrellas" for Greece and other struggling states.

Merkel tried to regain the initiative by shocking the European Union with a much broader call for eurozone reform—a comprehensive "pact for competitiveness" in line with Sarkozy's concept of an "economic government" for the eurozone. Merkel's "grand bargain" proposals ranged from common corporate rates to pension system reform, and include the abolition of wage indexation, constitutional amendments on debt limits, mutual recognition of education credentials, measures to promote cross-border labor mobility, and the establishment of national crisis management regimes for troubled banks. Her call for a eurozone-wide rise in the retirement age to sixty-seven was met by some EU leaders with hostility.

As a reflection of Merkel's lack of confidence in the Brussels bureaucracy, she pushes—with Sarkozy's backing—for implementing this pact directly through the "intergovernmental method" between the finance ministries of all seventeen eurozone members. Thus, the EU Commission of twenty-seven member nations would be sidelined, and the development of a two-speed European Union accelerated.

As expected, sharp disagreements opened up among EU leaders when Germany and France presented their initiative at the summit on February 4, 2011. The leaders of Belgium, Spain, Portugal, Luxembourg, and Austria strongly objected to the plan. Some of the ten EU countries that aren't in the eurozone, including Poland and the United Kingdom, warned that several of the suggestions could undermine the single European market. "Greece rejects Germany's proposals as unacceptable interference. Austria's chancellor also uses the term "interference," read the headline of *Eurointelligence Daily.*

"Spreading a flawed gospel for Europe—recasting the eurozone in Germany's image will not work," commented the *Financial Times.* And "France's fingerprints are on the latest proposals, but the handwriting is German." However, the paper concedes in a February 7 editorial, "There can be no doubt that the proposals reflect Germany's diagnosis of what has gone wrong in the first twelve years of European monetary union… Germany is the area's chief creditor and can therefore call the tune. The pact is Germany's price for displaying a readiness to be the eurozone's financial guarantor."

Wolfgang Munchau, a *Financial Times* columnist, asked pointedly, "Why dream about policy coordination mechanisms in a post-crisis world, instead of solving the crisis we already have?" He describes the real problem as "a crisis of contingent liabilities that arise from undercapitalized and nationally fragmented banking systems, aggravated by a competitiveness gap," and concludes that "it is surely not an attractive proposition for, say Spain, to have labor laws coming from Berlin, a currency from Frankfurt, but debts remain in Spain."

Before the Brussels summit in early February, Berlin again ruled out allowing the EU bail-out facility to fund bond buybacks from debt-strapped governments. Since both Germany and France are coming up with the largest contributions to the bail-out guarantees and funds, nothing

The European Central Bank is on the way to becoming Europe's "bad bank."

"Suicidal Irresponsibility and Farcical Incoherence"

Marco Annunziato *offers harsh assessment.*

Since German Chancellor Angela Merkel and finance minister Wolfgang Schäuble misread the fragile market conditions (almost no demand for peripheral bonds but a lot of risk aversion), Berlin's haircut proposal turned out to be a costly error, injecting new uncertainty into 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. Marco Annunziata, Unicredit Group's chief economist, reacted harshly. "The most recent antics on the sovereign debt restructuring mechanism are a breathtaking mixture of suicidal irresponsibility and farcical incoherence, and risk inflicting lasting damage to the recovery of the most troubled peripheral countries and to the credibility of the eurozone governance framework."

—K. Engelen

Merkel's Brain Trust

Merkel's three key advisors on Europe and the euro crisis have been at her side since she took over as chancellor of the previous "grand coalition" of the two Christian parties and the Social Democrats with Peer Steinbrück as finance minister.

Uwe Corsepius

Uwe Corsepius is Merkel's top advisor on EU matters. As the chancellor's chief negotiator with Brussels, he wields a lot of influence. *Der Spiegel* says Corsepius has "more power than most foreign ministers." After the Lisbon Treaty was initially rejected by the Irish in 2008, Corsepius worked hard as special negotiator to pick up the pieces and keep the treaty alive. Corsepius will leave the chancellery in the middle of this year to take over as Secretary General of the Council of the European Union.

Jörg Asmussen

Jörg Asmussen, though a member of the SPD, was asked by Merkel and finance minister Schäuble to stay on in the new conservative-liberal government coalition. A veteran finance ministry official, Asmussen played a key role in Germany's response to the financial crisis, including setting up the German Federal Agency for Financial Market Stabilization. In dealing with Brussels, Asmussen is a tough negotiator. When EU officials wanted to know why they could not set up the new European rescue facility, Asmussen replied, "We do not trust you." Asmussen also made sure that the German Finance Agency which handles the issuing of German government securities and Germany's debt management got the mandate to process the bonds issued by the Luxembourg-based European Financial Stability Facility, headed by Klaus Regling, a former German finance official.

Jens Weidmann

Jens Weidmann is Merkel's chief economic advisor who previously served as head of the monetary department at the Bundesbank. Together with Asmussen, Weidmann played an important role in the German government's response to the financial crisis. As Merkel's "sherpa," Weidmann organizes the G20 summits. One of the professors overseeing his doctoral thesis at Bonn University was Axel Weber, the current Bundesbank president. Weidmann was rumored to be moving to the Bundesbank's managing board later this year, before Weber effectively withdrew his candidacy to succeed Jean-Claude Trichet as head of the European Central Bank. Now Weidmann is Merkel's choice to succeed his former professor as head of the Bundesbank. In his farewell interview with *Der Spiegel,* Weber gave Weidmann strong support. "Weidmann is an excellent economist," Weber said. "He would carry out his duties well in any position, right from the first day." But there are strong objections in some quarters that sending Merkel's closest economic adviser to head the Bundesbank might put the institution's long-defended independence in doubt at a critical time when German citizens are losing confidence in the stability of the euro.

—K. Engelen

goes against the Franco-German *entente.* Germany and France together represent almost half the eurozone's gross output—Germany with a share of 27.2 percent and France with 21.3 percent. These shares are the basis for calculating the capital contributions to the EU institutions and also to the EFSF.

TRIAL-AND-ERROR MOVE THAT UNSETTLED MARKETS

In another dramatic unilateral trial-and-error move in October and November of last year, Merkel came out strongly for forcing banks and bondholders to pay their fair share in solving the euro crisis. She was responding to the growing resentment among German citizens that her government was protecting private bondholders—the banks and the financial sector—while putting the burden on taxpayers. In this respect, Merkel's "trial" move was to force bondholders to take losses—haircuts—as a precondition for bailouts that could help close a widening equity gap.

But since Merkel and finance minister Schäuble misread the fragile market conditions (almost no demand for peripheral bonds but a lot of risk aversion), Berlin's haircut proposal turned out to be a costly error, injecting new uncertainty into 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. Marco Annunziata, Unicredit Group's chief economist, reacted harshly. "The most recent antics on the sovereign debt

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restructuring mechanism are a breathtaking mixture of suicidal irresponsibility and farcical incoherence, and risk inflicting lasting damage to the recovery of the most troubled peripheral countries and to the credibility of the eurozone governance framework."

As the Bank for International Settlements recorded in its December 2010 *Quarterly Summary on Global Debt* under the heading "Euro area sovereign risk concerns resurface," "The surge in sovereign credit spreads began on 18 October, when the French and German governments agreed to take steps that would make it possible to impose haircuts on bonds should a government not be able to service its debt. Spreads widened further after a European Council statement on 28 October made it clear that other EU governments had agreed to the proposal. In the following weeks, Irish spreads went up by more than 200 basis points and the CDS spread curve inverted indicating that market participants now saw a more immediate risk of a negative credit event." The BIS continued, "To forestall further spread increases, the finance ministers of several European countries on 12 November reiterated that burden-sharing would apply only to bonds issued after 2013." This raises the question: Will all other outstanding sovereign eurozone bonds be safe from writedowns?

The BIS also clarified its definition of a "credit event." "Credit events specified by CDS contract clauses include default on scheduled payments and involuntary debt restructurings." So the German government's push for haircuts in order to calm voters and taxpayers unsettled bond investors, driving up interest costs for weak eurozone sovereign borrowers and pushing up the bail-out costs for all eurozone countries. At the December 2010 EU summit, ECB President Jean-Claude Trichet, using similar numbers, took a swipe at Merkel and Sarkozy for driving up the bail-out costs, thus reconfirming his fierce opposition to bondholder haircuts.

Capital market specialist Hans-Joachim Dübel argues that the spread widening could have remained contained and short-lived if Berlin had actually moved quickly on restructuring the old debts of periphery states, rather than making ultimately untenable promises to cover all of them and push bond market reforms to 2013. "It is the permanent state of insecurity about which bonds are actually guaranteed to be rolled over, and to what extent, which unnerves markets. Berlin wasted a window of opportunity, and its timing and communications blunder drove up the rescue costs for the euro."

STILL DENIAL, COVERUP, AND BLAMING OF OTHERS

One of the six points of Merkel's "pact for competitiveness" is the call for establishing national crisis management regimes for troubled banks. If Merkel and other European leaders want to solve the eurozone's frightening fiscal crisis, tackling the smoldering banking crisis as one of its root causes should be high on the agenda. But thorough inquiries into highly opaque national financial sectors and their linkages in the euro area and the European single market is a precondition for being able to design the right prescriptions.

This brings us to the recently published findings of the U.S. Financial Crisis Inquiry Commission, which was established under the Fraud Enforcement and Recovery Act of 2009. Its ten appointed commissioners had at their command a large staff of experts and far-reaching investigating powers. The report's findings concluded that the crisis was avoidable and was caused by widespread failures in financial regulation, including the Federal Reserve's failure to stem toxic mortgages; a dramatic breakdown in corporate governance; an explosive mix of excessive borrowing and risk by households and Wall Street; key policymakers ill-prepared for the crisis, lacking a full understanding of the financial system they oversaw; and systemic breaches in accountability and ethics at all levels.

Considering that in the wake of the financial crisis Germany ranked third after the United States and the United Kingdom in terms of the size of losses and public support financing at the expense of taxpayers, the question arises: Why has Germany not opened a similar broad inquiry into what really happened, who was responsible, and what must be done to clean up the damage?

Under Chancellor Merkel, sad to say, the German government's response to the financial turmoil has been essentially guided by what the powerful banking and insurance lobbies want. Merkel seems to be so conditioned to yield to domestic concerns that European and global implications are put aside. For Merkel and the two finance ministers she

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has worked with—Peer Steinbrück and Wolfgang Schäuble—protecting the interests of the German finance sector is the rule, with the corollary that profits are privatized and losses are socialized.

When it comes to protecting the national financial sector, Merkel and France's Sarkozy see eye-to-eye. Both have similar concerns, helping underpin bilateral cooperation. This explains why both are talking about what the weak eurozone countries must do, but avoid addressing the need for bank restructuring at home.

My first analysis of Germany's response to the worst financial crisis in decades after the subprime collapse was titled "Denial, Coverup, and the Blaming of Others" (*TIE,* Summer 2008).

The conflict of interest between politics and the private sector makes a thorough clean-up job difficult. Up to the highest government circles there was denial as to the gravity of the contamination damage of the subprime collapse. Contrary to actions in Switzerland, the United Kingdom, and the United States, it remains official policy to block any move toward more transparency. Three members of the Bundestag—Frank Schäffler (FDP), Gerhard Schick (Greens) and Axel Trost (Linke)—were mentioned in the article as asking tough questions. They tried hard to get Germany to appoint a similar financial crisis inquiry commission. Until recently, the official and private sector discussion was dominated by the blaming of others. This way, the broader public was conditioned to swallow—after the default of Lehman Brothers—a full state rescue of the whole financial sector and its creditors at taxpayer expense.

Thus, Merkel and Sarkozy have still a credibility problem as they pledge to rescue the euro with "whatever it takes." Both are still hiding from their taxpayers the bad news that *The Economist* detailed in its January 15, 2011, cover story: "The euro crisis: time for Plan B." The euro area's bail-out strategy isn't working and it's time for insolvent countries to restructure their debts.

The Problem in a Nutshell

The four big core countries—Germany, France, Belgium, and the Netherlands—have peripheral country exposure equal to around 125 percent of their banks' capital, so a hypothetical 25 percent depreciation in peripheral country assets will cause them to lose around one-third of their capital. Thus, a sovereign debt restructuring would be highly disruptive.

—*K. Engelen*

IT'S THE BANK RESTRUCTURING, STUPID

But after ten months of crisis and two country bail-outs, eurozone governments and EU authorities are still not telling the truth to their voters and taxpayers: the sovereign debt troubles of the eurozone cannot be solved without also tackling Europe's still-smoldering banking crisis in both the core and the periphery.

For fear of weakening their own banks and financial sectors by forcing them to write down billions of euros of the debt of Greece and other weak member states, the governments of Germany, France, and other economically strong countries put the brakes on any debt rescheduling and opted for the bail-out route. The reasons are simple. With contagion spreading from Greece onward to Portugal, Ireland, and Spain, it became ever more apparent that in a currency union, financial sectors have integrated to such a degree that the insolvency of one sovereign debtor or one banking system can cause havoc in the financial sectors operating on the investor side in a global market.

Here are some numbers. According to the calculations of JPMorgan, the four big core countries—Germany, France, Belgium, and the Netherlands—have peripheral country exposure equal to around 125 percent of their banks' capital, so a hypothetical 25 percent depreciation in peripheral country assets will cause them to lose around one-third of their capital. Thus, a sovereign debt restructuring would be highly disruptive for the core banking systems, potentially leading to shortages of bank capital.

A large amount of peripheral debt is still held by banks and other institutional investors such as insurance companies at purchase or nominal value on their books. And insecurity among bond investors is still high. Would solemn pledges from key European leaders to rescue the euro whatever it takes mean that the financially strong eurozone countries—with Germany in the lead under the new European Stability Mechanism—would have to guarantee at taxpayer expense the total outstanding sovereign and bank debt of peripheral member countries?

To this end, the present EFSF and then the new ESM would need to be expanded in terms of lending capacity and instruments so as to cope with the large exposures *vis-à-vis* peripheral sovereign debtors and banks. Although there are calls from all sides to get the triple-A-rated fund to its stated capacity as quickly as possible, there are no official proposals on the table to increase its headline capacity. While Germany is prepared to include direct purchases of distressed countries' bonds in the primary market into the toolkit, other instruments, such as lower interest rates on aid and boosting the EFSF "firepower," have yet to be decided on.

WHY IT'S REALLY GETTING COSTLY

Since the Greek liquidity crisis escalated into full-fledged solvency disaster in May last year, Merkel and her ruling coalition of the Christian Democratic Party, its Bavarian sibling the Christian Social Union, and the Free Democrats have still been raising the over-optimistic expectation that German taxpayers won't have to worry. There even is a lively discussion in the media about the paradox that so far Germany is profiting from the euro crisis, and that the government is earning big fees from its guarantees.

When Merkel's ruling parties pushed the €110 billion Greek rescue and shortly after the much larger €440 billion European rescue facility through the Bundestag, they did so with the fairy-tale story that Germany would provide guarantees without any cost to taxpayers.

The risk that one day such guarantees would turn into real losses for the German budget was disregarded. The German budget is already under heavy austerity pressures because of the "fiscal brake" that in 2009 was put into the German Constitution.

There is no lack of expert advice for improving the euro rescue, including cost estimates. Thomas Mayer, chief economist of Deutsche Bank, and Daniel Gros, director of the Centre for European Policy Studies, came up in May of last year with their proposal for a "European Monetary Fund." Now they have proposed "Debt reduction without default." Mayer and Gros estimate that investors will have to write off about €130 billion to €160 billion alone for Greece, Ireland, and Portugal on total exposures of some €490 billion to €520 billion.

In addition, JPMorgan economists Joseph Lupton and David Mackie propose subsidizing interest rates for member countries in intensive care. They conclude that "the cost of the large improvement in debt dynamics at borrowing rates 100 basis points over Germany represents a fiscal transfer. However, the cost is modest. We estimate the present value of the implicit cost of such a subsidy, if used to completely fund Greece, Ireland, Portugal, and Spain through 2020, to be €111 billion, or just 2.5 percent of the combined GDP of Germany and France."

END THE TABOO AGAINST DEBT RESTRUCTURING

That a country like Greece could get back to debt sustainability without a bond restructuring is not a realistic scenario. Rescuing the financially wrecked eurozone countries cannot be done merely by government guarantees and printing money by central banks. Someone will need to bear billions in losses. The taxpayers of Germany, France, and the other financially stronger countries will not get off the hook by simply sharing their triple-A debt ratings. How can confidence return when investors see that eurozone governments are not facing economic reality?

Berlin's haircut proposal turned out to be a costly error, injecting new uncertainty into markets.

This explains why markets are still nervous and why risk premiums for highly indebted eurozone members are still so high. The European crisis mechanism puts off burden-sharing by the finance industry through haircuts until June 2013, to happen on a case-by-case basis. That is too far into the future. The question is what happens now.

Since the beginning, Merkel and Sarkozy have remained under heavy pressure from banks and insurance groups. They may have succeeded in protecting their financial sectors from any debt restructuring of their bond portfolios by establishing the European bail-out facility at taxpayer expense, but such actions are highly questionable. This reality is sinking in even among Merkel's closest political allies. According to Kurt Lauk, head of the business caucus of the CDU's Economic Council, "European leaders should drop their 'taboo' against debt restructuring," indicating that the German government would have support "to take more aggressive action in stamping out the euro area crisis."

Hans-Joachim Dübel, who worked at the World Bank on housing finance in all parts of the globe, spells out what the European leaders should do. "Except for the Greek case which was caused by fiscal indiscipline, deleveraging banking systems and in particular highly indebted household sectors as a result of the housing bubble has absolute priority for the other problem members of the eurozone."

Dübel makes the point that key European crisis managers have not understood fully how much the fiscal problems in Euroland are caused by policy failures in managing the difficult mortgage sector. "Neither Spain nor Ireland, with high household leverage, have adopted any debt restructuring measures, which the United States started to do two years ago. Except for Ireland, defaulted developer and other corporate credit has not been ringfenced yet. Periphery banks have been forced to absorb even more local sovereign debt. All of this is possible only through rock-bottom ECB collateral standards and interest rates that keep the zombie portfolios and banks alive. Yet, even if the ECB wants to continue to play this role, trying to inflate away the periphery debt problem will not work, given its scale and slow economic growth. What is needed is a

European bank restructuring solution, something like a 'Bankentreuhand' that leads to both a uniform and decisive approach to bank resolution backed by sufficient European sovereign credit. Such an effort should form the core of European policy coordination."

Dübel has a valid point. The state of the German and French financial sectors should offer strong incentive to put in place a bank restructuring authority that can reach into the shattered banking systems of periphery member countries. European leaders must realize that a large part of what they perceive as a sovereign fiscal crisis in the periphery is in reality a lack of restructuring of bank portfolios and household debt in spite of the very low interest rates provided so far by the European Central Bank.

As the recent *Capital Markets Monitor* of the Institute of International Finance shows, as banks and other investors in the core eurozone massively reduce their portfolios in the weaker eurozone economies, local banking systems get even weaker and fiscal consolidation more difficult to achieve.

Those who have been dealing with sovereign debt crises since Mexico's default in 1982 are deeply worried about how EU leaders are handling the crisis. William Rhodes of Citicorp, who played a key role in sovereign debt restructurings throughout Latin America and Asia over the past three decades, believes the EU approach has fundamental flaws. The financial sector is worried by German indications that it will require a restructuring of private sector debt prior to any financial adjustment program, and before any official financial support. "This is not the way it works," says Rhodes. "The private sector needs to be consulted at a very early stage, and part of the process of judging debt sustainability is a highly consultative and cooperative process for resolving a debt restructuring and determining on what terms it will take place."

TABOOS, HYPOCRISY, AND AN "INNOVATIVE SOFTIE"

Talking about debt restructuring, Alfred Herrhausen, the former Deutsche Bank CEO, comes to mind. I happened to work with him to publish his cautious, but at the time extremely controversial, move to offer Latin American countries debt relief to ease the plight of the people and get their economies running again. For a top banker at the time even to think aloud about debt restructuring was considered taboo.

Handelsblatt published his piece just ahead of the IMF/World Bank annual meeting in the fall of 1987. Herrhausen's proposal became the talk of the annual meeting. He was attacked from all sides for thinking of haircuts on Latin bonds. Some of his German competitors, who later ran their banks into the ground, denounced him as an "innovative softie." The headline ran: "If bankers talk about debt relief, those thinking ahead live dangerously."

Through Herrhausen's press spokesman, I was invited into his car for a talk. We drove more than an hour through Washington. He was emotionally upset about "so much hypocrisy among his banker colleagues." He said that it was time to "stop this tragedy in Latin America." And he took a swipe at his German competitors, "who could only see his move as a ploy because Deutsche Bank had already written off 70 percent of Latin American debt." Looking at the eurozone debt crisis, do any top bankers today have Herrhausen's vision? ◆

The Herrhausen Vision

Alfred Herrhausen

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