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## Debt Problems Chip Away at Fortress Europe

By [LONDON THOMAS Jr.](#)

Fortress Europe is now under attack by the market.

For months, the conventional wisdom in Europe was that the speculative aims of bond traders and hedge fund investors would remain largely focused on Greece, Europe's chronic problem child.

But this week the cost of insuring the debt of not just Greece, but Portugal and Spain as well, rose to record levels — causing stock markets to tumble, [the euro](#) to fall, and borrowing costs in the most vulnerable countries to soar.

As a result, governments in the 16 countries that use the euro must now confront a new and disturbing reality: The deal they struck more than a decade ago to create a common currency area, hoping that a single central bank could manage to paper over the divergent economic and financial conditions of its members, is finally being challenged.

“This is the first big test for the European monetary system,” said Christopher Wood, an investment strategist for Credit Lyonnais securities in Asia. “And it is clear this year that global macro risk will come from Euroland and not the U.S.”

On Friday the cost of insuring Greek, Spanish and Portuguese debt eased from their record highs — perhaps on comments made by Dominique Strauss Kahn, the managing director of the [International Monetary Fund](#), that the fund was ready and willing to help Greece if asked to do so.

But the billions of dollars being traded in the market for [credit default swaps](#) on government bonds suggested that investors were not retreating from their expectation that the gap between Europe's laggard periphery and

its recovering core — Germany, France and the smaller countries of northern Europe — would keep widening.

As this is an effective bet that peripheral governments will not have the stomach to push through tough reforms, bond investors are spending as much time analyzing the power of Spanish and Greek unions as they do the spreads on credit default swaps.

In [Deutsche Bank](#)'s weekly fixed income report, for example, analysts highlighted a Greek public sector strike on Feb. 10 and another one on Feb. 24 while also drawing attention to the possibility that Spanish unions might strike later this month to protest the increased retirement age.

The Greek government's ability to make a good impression on its coming road show to America and Asia next month will also be a key benchmark.

While Greece's finance minister has said that yields of almost 7 percent are high enough to give investors a good return for the risk involved, the fact that the Greek government must raise almost half of its funding requirement of 53 billion euros this spring in an increasingly skeptical market gives investors concern.

Investors will be also wary of any more incomplete bond auctions like the one that hit Portugal on Wednesday when the government pared back the amount of bonds it was going to sell due to a sharp spike in the bond yield.

Adding to the unease in Portugal is a showdown next week in parliament that could force the government in Lisbon to admit that it will not be able to keep its promise to hold the budget deficit this year to 8 percent of G.D.P.

And another gloomy economic report from Madrid on Friday showed economic activity was down a sharp 3 percent for the final quarter of 2009 from the year before, meaning that Spain remained one of the few major countries still in the grip of recession.

The speculator's bet is a simple one.

In an era in which government budget deficits have soared in response to the financial crisis, the same bond

vigilantes that forced President Clinton to balance the American budget in the 1990s have turned their attention to the countries on Europe's southern flank.

In effect, they have challenged those relatively weak governments to raise taxes and impose harsh spending cuts on a restive populace to bring down their deficits from over 10 percent of G.D.P. to the benchmark levels close to 3 percent of G.D.P. called for in the European treaty that created the euro.

While such moves are highly unpopular politically, a failure to do so could send government borrowing costs soaring, enriching those who are betting that Greece, Portugal, Spain and perhaps even Italy will not be able to follow through on their commitments.

[Joseph Stiglitz](#), the international economist who is an adviser to the Greek government, sees the investor demands as lacking in merit. Indeed, he points to the inherent contradiction in allowing the richer countries in Europe to borrow heavily to pull themselves out of recession while the poorer countries are forced to take a knife to the very programs intended to soften the blow of an economic downturn.

“If you tighten the way the markets seem to want you will get a political response that is non-viable,” he said, drawing a comparison to Iceland, where popular discontent forced the country's president to abrogate a controversial agreement to repay foreign creditors. “These are democracies — not dictatorships.”

Mr. Stiglitz proposes that Europe's richer countries like Germany and France take the lead in aiding Greece — for the sake of the European whole, however shaken it might be.

But that may be easier said than done.

The charter establishing the euro, while supposedly ruling out any bailouts by the [European Central Bank](#) or member governments, also failed to establish any mechanism for providing funds to countries in financial trouble. That is the kind of role normally taken on by the International Monetary Fund, but Europeans are determined to keep the I.M.F. away from nations within the eurozone because of the questions it might raise about the viability of the common currency.

[European Union](#) nations outside the eurozone, like Romania, Latvia and Hungary, have received support from

the I.M.F., which then imposed various fiscal requirements intended to insure they can pay back the loans.

But for those countries using the euro the stability pact that was charged with monitoring member country finances was thought to be sufficient to keep countries in line. Greece's consistent and premeditated pattern of skirting the fiscal standards set by the [European Commission](#) has dashed those beliefs.

Miranda Xafa, a former executive board member of the I.M.F., believes that the time has come for Europe to acknowledge that it has neither the technical expertise to monitor government behavior nor the ability to quickly raise rescue funds. Only the I.M.F., she argues, is capable of truly doing that job.

"Greece's economic fundamental are by far the worst in the eurozone," she said. "The I.M.F. coming in would also help the other countries and restore confidence."

But in Brussels, turning to the I.M.F. is seen as conceding that the monetary union cannot care for its own.

Whether Europe can hold out much longer, though, remains in doubt. Jonathan Tepper, a partner at Variant Perception, a research firm that caters to hedge funds, argues that the rising borrowing costs for countries like Greece and Portugal are a sign that the economic problems in Europe's south are deep and will not disappear without a long and painful readjustment.

"People are just dumping debt," he said. "It is pure risk aversion that is pushing spreads higher."

For Greek, Spanish and Portugal governments that still need to raise billions from these very markets over the next few months, that is bad news indeed.

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