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In Latest Greek Bailout, Warning Signs for Europe

The New York Times

By PETER EAVIS | New York Times – 3 hours ago

European leaders have approved their latest aid package for Greece, raising hopes that the worst phase of the sovereign debt crisis is over and a persistent source of stress on global markets has been removed.

But Greece's 130 billion euro ($172 billion) bailout highlights the weaknesses in Europe's response to the crisis, some analysts say. The worry is that these problems could flare up and undermine recovery efforts in countries like Italy, Spain, Ireland and Portugal.

"I don't want to be a Cassandra, but the idea that it's over is an illusion," said Kenneth S. Rogoff, a professor of economics at Harvard University and co-author of "This Time Is Different: Eight Centuries of Financial Folly." "I am amazed by the short-term psychology in the market."

Throughout the crisis, the European Union's favored strategy has been to provide tightly controlled financial support to highly indebted countries, in the hope of buying them enough time to implement policies aimed at cutting budget deficits. While such moves can deepen recessions, the goal is to eventually lower debt levels and win back the confidence of the bond markets.

On the margins, investors are becoming more optimistic. The Continent's stocks and government bonds have rallied sharply this year on the belief that Greece would avoid a disorderly exit from the euro.

But Greece's fate has exposed the severe limitations of Europe's approach to the crisis.

Austerity policies contributed to an estimated 6.8 percent drop in the country's gross domestic product last year. In 2010, the International Monetary Fund had forecast that Greece's economy would only shrink 2.6 percent in 2011.

Greece is also resorting to a move that European officials initially wanted to avoid at all costs. The country is going to reduce its overall debt load by requiring some creditors to take losses on Greek bonds. In total, the restructuring will mean private sector holders of Greek bonds take a hit of more than 70 percent. Though this amounts to a default, European officials hope the managed nature of the debt restructuring will prevent the move from destabilizing markets.

European officials want to avoid undertaking similar measures for other countries. Last year, after European officials suggested debt restructurings might be used beyond Greece, the region's government bonds sold off. The market reaction prompted officials to remove write-downs from the crisis management toolbox -- at least for now.

To avoid such a situation, European officials have introduced a range of measures over the last year that may buy more time for struggling countries.

The European Union is setting up large pools of money to make emergency loans. The region's leaders have agreed to move toward more coordinated fiscal policies, which may pave the way for richer countries to transfer funds to poorer ones. And in December, the European Central Bank lent $620 billion to the region's banks, preventing a bank run in Europe and helping firms finance continued purchases of government bonds. Spain's government has already sold more than 30 percent of the $114 billion worth of bonds it was hoping to issue this year.

But one of the lessons of the post-crisis period in the United States is that monetary stimulus may only temporarily lift the markets and can take a long time to seep into the real economy. Some economists believe that, although the European Central Bank has stepped up its response to the crisis, its policies are not yet as accommodative as those of the United States Federal Reserve.

For instance, the Fed, in its most forceful stimulus measure, spent hundreds of billions of dollars buying bonds, supplying banks with immense amounts of cash that they were free to use as they wished. The E.C.B. did something different with its $620 billion of loans in December. Banks had to post collateral against the money they borrowed. While the banks get cash, they still have to pay back the central bank loans in the future, and they remain exposed to the assets they posted as collateral. As a result, the E.C.B. facility may have less effect than the Fed's bond buying, said Guy Mandy, a strategist at Nomura International.

Even in the United States, monetary stimulus did little to repair the balance sheets of the most debt-laden sectors of the economy. That means European government debt levels may take a lot longer to fall than officials hope. Certain governments may then require even more aid because they will not be able to sell bonds into private markets at affordable interest rates.

As with Greece, aid-disbursing countries like Germany might demand even tougher conditions on loans. But doing this can set up potential flashpoints that threaten to destabilize domestic politics and markets. "This creates a rolling crisis," said Silvio Peruzzo, an economist at the Royal Bank of Scotland.

Raoul Ruparel, head of economic research at Open Europe, a policy group that is sometimes skeptical of the need for closer European integration, said, "The approach failed monumentally in Greece."

For a while, the European Union may decide to keep giving aid to countries that do not meet targets, but this could create wider political conflicts in Europe. "It could drive a wedge between north and south in political terms in Europe," Mr. Ruparel said.

If troubled countries find they cannot comply with the loan conditions - and their richer neighbors grow increasingly impatient - they may have to follow Greece's lead.

The idea with Greece was that private investors, not just governments, needed to foot some of cost of the country's aid package, so they were pressured to accept losses on Greek government bonds. If another country finds it very difficult to comply with European Union and I.M.F. targets, "Germany and other countries will support the idea that the private sector has to pay its fair share of the debt relief," Mr. Peruzzo said.

Darren K. Williams, an analyst at AllianceBernstein, said: "I think that would be a huge error that could cause all sorts of other problems. It'd make Greece a template."

The big risk is that investors, fearing debt write-downs in many countries, would dump European government bonds, triggering new financial and economic weakness in Europe.

But some investors see few options for countries like Italy, whose debt is at 120 percent of G.D.P., and whose government bond market is among the largest in the world.

"Italy is essentially in a sovereign debt trap," said Richard Batty, global investment strategist at Standard Life Investments.

For Italy's debt to be sustainable, the country's economy either needs to grow at a nominal rate of 5 percent a year, or the interest rate on its 10-year bond needs to be at 3.6 percent, Mr. Batty estimates. During Europe's most recent boom period, from 2002 to 2007, Italy's nominal G.D.P. grew at an average rate of 3.6 percent, Mr. Batty said. Meanwhile, its 10 -year bond, even after a big rally this year, has a yield of 5.43 percent.

"I don't think we're anywhere near the endgame," Professor Rogoff of Harvard said.

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