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Tim Shufelt, Financial Post

EU plan invites risk taking; Moral Hazard

The master plan to save Europe, while well received in financial quarters Thursday, could very well ensure the crisis persists.

By subverting marketbased accountability, and essentially rewarding those who borrow, lend and spend irresponsibly, the framework invites risky behaviour and discourages restraint and restructuring, say critics of state bailouts.

"It's the worst of both worlds," said Raoul Ruparel, an economic analyst at Londonbased think-tank Open Europe. "It not only bails out the fiscally irresponsible states, but also the irresponsible bondholders and banks who invested in these countries."

Pressed on by international exasperation and aversion to being pegged with a global recession, eurozone officials devised a plan this week to choke off contagion that grew from the accumulation of state debt.

The agreement includes a voluntary 50% writedown by Greece's creditors, to be financed by a commitment of up to ¤100-billion ($140.58billion) by the European Union and the International Monetary Fund.

A recapitalization of distressed banks will require a total of ¤106-billion to meet new capital requirements. And the capacity of the bailout fund will be increased to about ¤1-trillion.

The plan is not without pain for the architects of the region's imbalances.

Banks will be compelled to accept a haircut, which will reduce the burden on the

European taxpayer - an element missing from the 2008 bailouts in the United States, which valued distressed assets at 100¢ on the dollar.

But the 50% writedown negotiated by the region's banks falls short in comparison to the market value of those toxic sovereign bonds.

"The eurozone crisis is a story of broken promises," Ms. Gewaltig said.

And the debt forgiveness plan will only allow Greece to achieve a 120% debt-to-GDP ratio by 2020 - hardly the restoration of fiscal health.

"And you consider the fact that these banks have had a year-and-a-half to reduce their exposure, or mitigate their exposure," Mr. Ruparel said.

"They haven't prepared for that."

Irresponsible lending has partly been a function of the eurozone's composition, under which the capital requirements for sovereign debt are non-existent, said Mark Calabria, director of financial regulation studies at the Washington, D.C.-based **Cato Institute.**

"You could literally hold Italian debt with no capital backing it."

But the existence of the incentive should not absolve the financial sector of its responsibility in funding state deficits, he said.

Having largely escaped punishment, however, the banking sector faces little deterrent to risky lending.

Peripheral sovereigns, meanwhile, having run up deficits and piled on debt to finance retirement entitlements and bloated public sectors, did not get off scot-free.

Greece and Italy have had painful and unpopular austerity programs imposed on them as a condition of support. Greece, however, has consistently missed its fiscal targets and continues to receive support.

The motivation for Italy to tackle its debt problem is accordingly diluted.

"Where's the incentive for them to restructure if the rest of the euro area is going to continue to support their bond market?" Mr. Calabria asked.

In both state and financial sectors, the plan promotes moral hazard.

But for the European Union to take any different route was widely regarded as unthinkable.

That bailouts are the only palatable option is a legacy of Lehman Brothers Holdings Inc., which has loomed large over the eurozone crisis, Mr. Ruparel said.

European leaders were told repeatedly the default of Greece - a country accounting for less than 3% of eurozone GDP - would alone risk invoking a Lehman-style event with ensuing market carnage.

"That's become a massive overgeneralization. It's a substantially different situation," he said.

The devastation wrought by Lehman was much a function of its mishandling by U.S. officials. The rescue of Bear Stearns Cos. created the expectation that Lehman itself would be bailed out, Mr. Calabria said.

On that expectation, Lehman Brothers turned down offers to purchase, making the bank's ultimate failure a shock that hammered global markets.

Exposures to Greece, by contrast, have been well-documented over the past 1½ year.

"The absolute wrong lessons have been learned from Lehman," Mr. Calabria said.

The eurozone should heed another warning offered by the U.S. experience of 2008 - bailouts beget bailouts.

Each successive rescue seemed only to fuel additional fires at which the government could only spray more money.

And the imbalances remain, with the U.S. housing market more depressed than ever and banks still carrying mortgage-related assets at inflated values.

However, now in the eurozone, an unmistakable message has been sent to the region's banks that haircuts must be voluntary and the bailout is always there.

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