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ECB prepares legal grounds for euro rupture as Greece festers

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By Ambrose Evans-Pritchard
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http://www.telegraph.co.uk/finance/comment/7012297/ECB-prepares-legal-ground-for-euro-rupture-as-Greek-crisis-escalates.html

Fears of a euro breakup have reached the point where the European Central Bank feels compelled to issue a legal analysis of what would happen if a country tried to leave monetary union.

"Recent developments have, perhaps, increased the risk of secession (however modestly), as well as the urgency of addressing it as a possible scenario," said the document, entitled "Withdrawal and Expulsion from the EU and EMU: Some Reflections."

The author makes a string of vaulting, Jesuitical, and mischievous claims, as EU lawyers often do. Half a century of ever-closer union has created a "new legal order" that transcends a "largely obsolete concept of sovereignty" and imposes a "permanent limitation" on the states' rights.

Those who suspect that the European Court has the power pretensions of the medieval papacy will find plenty to validate their fears in this astonishing text.

Crucially, the author argues that eurozone exit entails expulsion from the European Union as well. All EU members must take part in EMU (except Britain and Denmark, with opt-outs).

This is a warning shot for Greece, Portugal, Ireland, and Spain. If they fail to marshal public support for draconian austerity, they risk being cast into Icelandic oblivion. Or for Greece, back into the clammy embrace of Asia Minor.

ECB chief Jean-Claude Trichet upped the ante, warning that the bank would not bend its collateral rules to support Greek debt. "No state can expect any special treatment," he said. He might as well daub a death's cross on the door of Greece's debt management office.

This euro-brinkmanship must be unnerving for the Hellenic Socialists (PASOK). Last week's E1.6 billion (L1.4 billion) auction of Greek debt did not go well. The interest rate on six-month notes rose to 1.38 percent, compared to 0.59 percent a month ago. The yield on 10-year bonds has touched 6 percent, the spreads ballooning to 270 basis points above German Bunds.

Greece cannot afford such a premium for long. The country must raise E54 billion this year -- front-loaded in the first half. Unless the spreads fall sharply, the deficit cannot be cut from 12.7 percent of GDP to 3 percent within three years. As Moody's put it, Greece (and Portugal) face the risk of "slow death" from rising interest costs.

Stephen Jen from BlueGold Capital said the design flaws of monetary union are becoming clearer. "I don't believe Euroland will break up. Too much political capital has been spent in the past half century for Euroland to allow an outright breakage. However, severe 'stress-fractures' are quite likely in the years ahead."

As Portugal, Italy, Ireland, Greece, and Spain (PIIGS) slide into deflation, their "real" interest rates will rise even higher. "It is tantamount to hiking rates in the already weak PIIGS," he said. This is the crux. ECB policy will become "pro-cyclical," too tight for the South, too loose for the North.

The City view is that the North-South split may cause trouble but that there will always be a bailout to prevent a domino effect. "If a rescue turns out to be necessary, a rescue will be mounted," said Marco Annunziata from Unicredit.

It comes down to a bet that Berlin will do for Club Med what it did for East Germany: subsidise forever. It is a judgment on whether EMU is the binding coin of sacred solidarity or just a fixed exchange rate system like others before it.

Politics will decide, and in Greece it is already proving messy as teams of "inspectors" ruffle feathers. The Orthodox LAOS party is not happy that an EU crew dared to demand an accounting from the colonels. "The Ministry of Defence is sacrosanct," it said.

Greece alone in Western Europe treats the military budget as a state secret. Rating agencies guess it is a ruinous 5 percent of GDP. Does the country really need 1,700 battle tanks, 420 combat jets, and eight submarines? To fight NATO ally Turkey? Merely to pose the question is to enter dangerous waters.

Who knows what the IMF surveillance team made of their mission in Athens. The fund's formula for boom-bust countries that squander their competitiveness is to retrench *and* devalue. But devaluation is ruled out. Greece must take the pain, without the cure.

The policy is conceptually foolish and arguably cynical. It is to bleed a society in order to uphold the ideology of the European Project. Greece's national debt will be 120 percent of GDP this year. S&P says it will reach 138 percent by 2012. A fiscal squeeze -- without any offsetting monetary or exchange stimulus -- will cause tax revenues to collapse. Debt will rise higher on a shrinking economic base.

Even if Greece can cut wages without setting off mass protest, it lacks the open economy and export sector that may yet save Ireland in similar circumstances. Greece is caught in a textbook deflation trap.

Labour minister Andreas Loverdos says unemployment would reach a million this year -- or 22 percent, equal to 30 million in the US. He broadcast the fact with a hint of menace, as if he wanted Europe to squirm. Two can play brinkmanship.

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