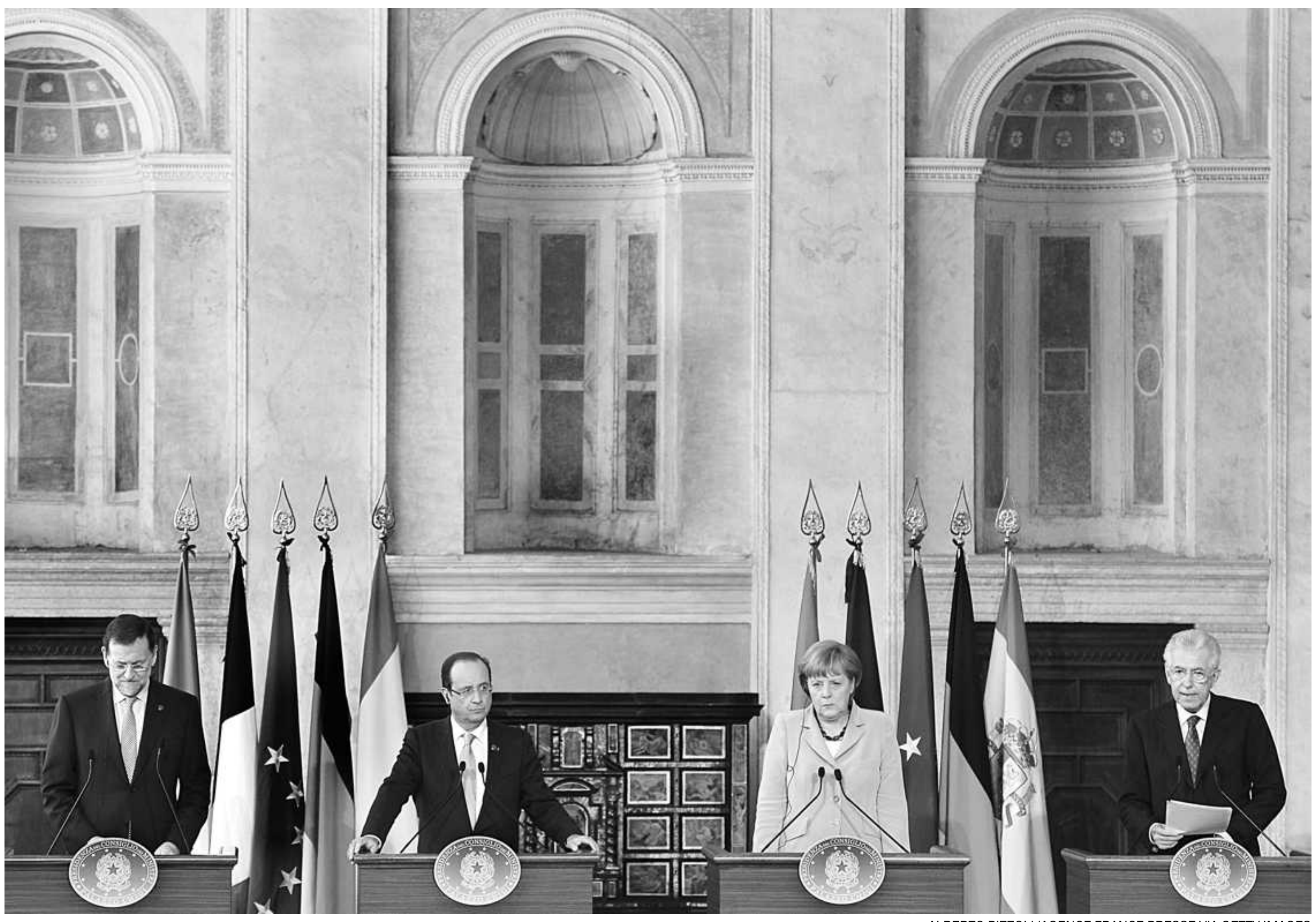
# ON THE MONEY



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**Spanish Prime Minister Mariano Rajoy, from left, French President Francois Hollande and German Chancellor Angela Merkel listen as Italian Prime Minister Mario Monti speaks during a joint news conference following their meeting in Rome.**

STEVEN PEARLSTEIN

## *To save the euro — and Italy — Monti's efforts may be the best hope*

PEARLSTEIN FROM G1

about winning the next election. It also helps that he has the respectful ear of President Obama.

Most significantly, Monti is well-positioned to act as the honest broker between France's new socialist president, Francois Hollande, who wants to shift the focus of European policy to pro-growth fiscal and monetary stimulus, and German Chancellor Angela Merkel, a stubborn champion of hard money, tight budgets and market-friendly structural reforms. As the leader of an economy shrinking at the annual rate of 2 percent or more, Monti is determined to put growth back at the top of the European policy agenda. At the same time, his tough moves to raise taxes, cut spending and reform Italy's notoriously uncompetitive labor and product markets have won him credibility with Merkel and investors.

In truth, there is no simple Keynesian solution by which the euro zone could borrow-and-spend its way back to growth. With the notable exceptions of Germany and a few of its smaller, northern neighbors, borrowing costs for most of the continent are simply too high, and if those two countries were to try to stimulate with tax cuts or increased government spending, the spillover effects on the rest of Europe would be modest at best.

What would work would be if Europe as a whole could borrow money not to spend it for the sake of spending, or on unsustainable welfare payments, but to invest it in genuinely Europe-wide energy, transportation, education and environmental projects that would enhance the efficiency and productivity of the region's economy over the long run. Money from such euro bonds could also be borrowed, as well as raised from private investors, to expand the existing European Investment Fund, which makes investments in the innovative small and medium-size firms that account for much of the job growth in Europe and which have been starved for capital as a result of the ongoing financial and banking crisis.

On Friday, Monti and his three colleagues talked about committing 1 percent of Europe's GDP to this purpose — about $175 billion. At a time when governments are cutting several times that much from their operating budgets, and private capital is constrained, surely that's at the very low end of the range they should be considering.

At this point, however, the bigger impediment to European growth is not the insufficient level of government spending and investment. It is the insufficient level of private spending and investment due to the loss in confidence caused by the twin banking and government debt crises. The two crises, in effect, are now one and the same. Troubled governments are borrowing to bail out banking systems while their banks are trying to help their governments by loading up on government bonds — a process likened by Martin Wolf of the Financial Times to two drunks remaining upright by leaning on each other.

Two things should be obvious. The first is that European governments cannot, and should not, be called upon to bail out shareholders and creditors of banks that have made bad loans or taken bad risks. The other is that European banks cannot, and should not, be called upon to use their depositors' money to bail out governments that can't control their spending. Each bank and each country has to be allowed to stand and fall on its own, subject to its own market discipline and pricing of risk. The only ones who should be protected are retail bank depositors, through properly priced deposit insurance.

Everyone pretty much agrees on that — the problem is getting from here to there. And, once again, the answer is for European countries to borrow money collectively — that's those euro-zone bonds again — to recapitalize the European banking system. This investment will largely pay for itself in terms of restoring investor confidence, restoring consumer confidence and putting the European economy back on a growth path. The best recent evidence we have of that comes from the much-maligned Troubled Assets Relief Program in the United States, which did just that and wound up costing taxpayers almost nothing.

Why should German and French taxpayers put themselves on the hook to recapitalize banks in Spain and Italy?

For starters, it may turn out that some of those weak banks might not only be in Spain and Italy, but in Germany and France, where there is a long history of bankers and regulators conspiring to hide problems. The important intellectual hurdle for Europeans to get over is that these are not French or Spanish or Italian banks — they are European banks that have on their books large amounts of bonds from multiple European countries. It's also important to understand that the recapitalization of these banks would be done in the context of creating a Europe-wide bank regulation and deposit-insurance program that would create a stronger and more efficient European banking system.

Moreover, in most cases this need not be about "bailing out" banks, in the way most people understand that term. It should be about buying them, the way JPMorgan Chase bought Washington Mutual and Wells Fargo bought Wachovia. Yes, a bit of borrowed euro-zone money might be necessary to grease the deals if the banks turn out to be insolvent. But the amounts are likely to be modest and, as the United States proved, can be recovered once the economy has rebounded through minority stakes in the combined entities. To reduce the political fallout, shareholders and creditors in the weak banks could be forced to take haircuts and bank executives could be sent packing.

Solving the banking crisis, I suspect, would go a long way toward solving the sovereign debt crisis in most countries. But in the short term, it may also be necessary for Europe to prop up the bonds of countries that, like Italy, have demonstrated that they have done what is necessary to put their fiscal house in order. That's why Monti is pushing to authorize the new European Stabilization Fund to act as the "sovereign buyer of last resort" when financial contagion strikes.

Once again, however, the key point is that the Fund should be financed not by separate borrowings by the Spanish government, and the Italian government, and the Portuguese government, all which have to pay rates of 6 percent or more. Instead, it should be financed at half the cost by the E.U. as a whole, which would be able to borrow at rates closer to the German rates of less than 2 percent. To do otherwise is to simply double or triple the cost to preserve a political figleaf.

And who is standing in the way of Monti's plan for using European bonds for genuinely European purposes? Germany's Merkel, who as one official put it to me this week, seems to believe that economics is a branch of moral philosophy. Her attitude is rather ironic coming from a former resident of East Germany, which was literally pulled up to Western living standards by the taxpayers of West Germany after the fall of the Berlin Wall. And it is stranger still coming from the leader of a country that, just 75 years earlier, was rebuilt from the rubble of war with investment funding from the United States.

In private meetings, Merkel claims that German voters will simply not accept anything that smacks of subsidizing lazy and profligate southern neighbors. But what is also very clear is that the German chancellor and her colleagues have done nothing — and I mean nothing at all — to educate Germans that their own economic success over the past 20 years has been due not just to their hard work and efficiency, but also to the fact that their largest trading partners were allowed and encouraged to live beyond their means. Nor have they explained that, at this point, the cost to Germans of fixing the problem will be less than the cost of letting the recession and the market contagion spread.

Merkel has made her point: European assistance must be offered only to countries such as Italy, Ireland and Spain, which have genuinely committed themselves to changing their ways and getting their economic acts together. But at this point, by preventing reasonable collective action to end the euro crisis, Merkel is on the verge of proving the Euro-sceptics right. What she demands is that everyone else in Europe start to think and act like Europeans while Germans continue to think and act like Germans.

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To see previous columns by Steven Pearlstein, see postbusiness.com.


PABLO BLAZQUEZ DOMINGUEZ/GETTY IMAGES

**Newspapers covering the euro-zone crisis for sale at a shop in Madrid. Monti is pushing to authorize a fund to act as the "sovereign buyer of last resort" when financial contagion strikes.**

## *Foreclosure machinery creaks back to life*

Barry Ritholtz

ON INVESTING

Ever since the robo-signing scandal erupted in October 2010, large U.S. banks have slowly come to realize that their practices are under ever-increasing scrutiny. A "Duh!" observation for most people, but not, apparently, for bankers.

Belatedly, the bankers took a closer look at their internal procedures for handling defaulted mortgages. It did not take long for them to discover that something significant was amiss. By mid-2011, most of the major money center banks had put the brakes on their normal foreclosure machinery: "What was all this sturm und drang over some bums who don't pay their bills? Perhaps we better look into it."

Their internal review of how mortgages in default were handled revealed a surprising amount of chicanery. Indeed, most of what was going on had elements of something wrong. The banks might have been better served had they asked the question: "Are we doing anything legally?"

As it turned out, not very much.

Large banks had long used outside law firms and third-party service processors to pursue recoveries from debtors. What made this cycle so different was the sheer volume: A massive increase in foreclosures combined with a big upsurge in outside vendors to process them. The combination ran roughshod over centuries of property laws, to say nothing of well-established banking procedures and legal practices.

Using third parties did not protect the banks from liability. As it turns out, subcontracting fraud does not insulate your organization from the illegal behavior of your hires. This created a problem for the banks.

Eventually, some smart executive figured out exactly how rampant the illegal robo-signings had become and halted the runaway foreclosure process. Even though it was temporary, it gave the banks some time to try to clean up their acts. While there was hope of a settlement (as opposed to prosecution), the banks stopped processing defaulted home loans. This voluntary foreclosure abatement continued even as negotiations plodded on with the U.S. attorney general. Thus, with the foreclosure pipeline shut down for well over a year, home prices stabilized and distressed sales fell as a percentage of total home sales.

Ultimately, the attorneys general settlement amounted to a mere slap on the wrist for the banks in light of the institutionalized fraud that occurred.

With all that legal unpleasantness behind them, the voluntary foreclosure abatements quietly ended. This year, the banks began to once again review unpaid home loans. It takes a while for the creaky, wheezy, inadequate machinery of processing defaulted mortgages to rumble back to life. So it has — and we should expect to see signs of increasing foreclosures and distressed sales any day now.

The first data point supporting this was April's existing-home sales. That gave us an early clue about what was to come. During the abatement period, distressed home sales, including foreclosures and short sales, had fallen substantially. They were down to 28 percent of existing-home sales for April – significantly less than the 37 percent a year earlier.

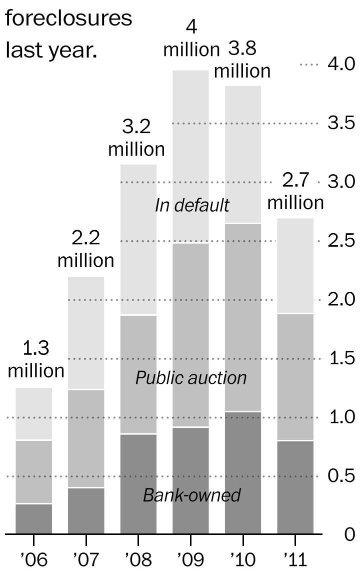
Distressed homes tend to sell for about 20 percent less than non-distressed sales.

The voluntary foreclosure abatement not only reduced the number of foreclosures, but also created the appearance of improving home prices. In reality, it was merely temporarily removed low-price, distressed properties from the overall pool of homes for sale.

That fortuitous set of circumstances appears to be over. Current foreclosure filings — default notices, scheduled auctions and bank repossessions — increased in May by 9 percent, according to the RealtyTrac monthly foreclosure report.

### Foreclosures

Bank foreclosures climbed after the housing bubble burst. When the robosigning scandal was uncovered in 2010, banks halted their foreclosures, leading to a significant drop in foreclosures last year.




Source: RealtyTrac THE WASHINGTON POST

This was right on cue. With the abatements over, foreclosure starts are creeping up again. As the foreclosure machinery ramps up, the negative ramifications they bring will expand. More distressed sales, lower prices and increasingly tough comparable appraisals are likely over the next 12 months.

To give you an idea of what is in store, consider this amazing statistic, courtesy of Laurie Goodman, housing analyst at Amherst Securities: 2.8 million Americans are 12 months or more behind on their mortgages. That degree of delinquency leads to an overwhelming percentage of foreclosure starts. It is reasonable to expect that 95 percent of these will end up as a foreclosure, distressed sale or walkaway.

As you might imagine, Goodman is not expecting a quick housing turnaround. An "L"-shape recovery is the most likely outcome, she says. Home prices still have 3 to 5 percent more downside. And, Goodman notes, they are likely to stay flat for three to five more years.

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Credit availability is another factor holding housing activity down. In a May 30 research report, Goodman analyzed the credit scores of existing homeowners. "Since 2007, 19 percent of all borrowers (about 9 million mortgagees) have gone more than 90 days delinquent on their mortgages, or have had their mortgage liquidated," she wrote. "Based on this delinquency alone, nearly all of these borrowers would be unable to qualify for credit today."

Why does this matter? Consider what removing one in five people who qualified for a mortgage not too long ago does to the demand side of the housing market. The 90-day delinquency on their credit reports prevents them from qualifying for a mortgage. Removing those people as potential home buyers amounts to a huge reduction in demand.

After an era of easy credit and no-documentation loans, the pendulum has now swung in the opposite direction. Despite the cheapest housing prices in a decade and the lowest mortgage rates on record, potential buyers simply do not qualify for loans at current credit standards.

This does not bode well for an immediate housing recovery.

We are, according to Goodman, "overcorrecting for the sins of the past."

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