Merkel's 'Moralistic Hysteria' Ban Unsettles Debt, Currencies

By Pierre Paulden

May 19 (Bloomberg) -- German Chancellor **Angela Merkel**'s unilateral attempt to rein in speculators and build support for a $1 trillion bailout is backfiring in debt and currency markets.

"It's moralistic hysteria," **Charles Dumas**, research director at Lombard Street Research Ltd. in London, said in an interview on Bloomberg Radio. "If she starts a heavy push to try and broaden this thing out to become a European rule it could cause a lot of trouble."

Volatility measures rose as German regulator BaFin, seeking to calm Europe's financial markets, banned traders within the country from buying default protection on government bonds they don't own. The move fails to address deficits and surprised markets, suggesting more "vulnerability in the eurozone than investors had anticipated," said **Christopher Garman**, chief executive officer of Garman Research LLC in Orinda, California.

The JPMorgan G7 Volatility Index, which measures the perception of risk in the currency market, rose for a fourth consecutive day and traded as high as 14.98 percent. It rose to 15.93 percent on May 6, the highest level since June 2009.

Merrill Lynch's **MOVE Index**, an options-based gauge of expectations for price swings in Treasuries, rose to 97.2 yesterday from this year's low of 74.10 on March 17. The reading means traders expect a yield range of 92.2 basis points on an annualized basis in the coming month.

A Europe-wide ban following Germany's is "doubtful," **Eddy Wymeersch**, Europe's top market regulator, said in a telephone interview today. European Union Financial Services Commissioner **Michel Barnier** said the rules would have been "more efficient" if they were coordinated with the EU.

'Counterproductive' to Euro

"This uncoordinated effort is counterproductive to the long-term survival of the euro," Garman said. "While it may temporarily alleviate what they see as the animal imagery of locus and wolfpack, or however else they describe speculators, it adds to a climate that's becoming more uncertain by the day."

Merkel told lawmakers in Berlin today that her country would act alone if needed, saying the national ban will last until a European solution is found. She said the ban on naked short-selling is part of her proposals to gain control over "destructive" financial markets.

The euro is at risk and Europe may be facing its greatest challenge since the founding of the European Union, with "incalculable" consequences if leaders fail to act, Merkel said.

The ban failed to reduce the rate banks pay for three-month loans in dollars, which has risen to the most in more than nine months.

Libor Rises

The London interbank offered rate, or Libor, rose for a sixth straight day, reaching 0.477 percent today, from 0.465 percent, according to data from the British Bankers' Association. That's the highest since July 31.

The dollar Libor-OIS spread, a gauge of banks' reluctance to lend, rose to 25 basis points from 24 basis points, the highest since Aug. 13. The spread, which compares three-month dollar Libor and the overnight indexed swap rate, ballooned to 364 basis points, or 3.64 percentage points, after the 2008 collapse of Lehman Brothers Holdings Inc.

The Markit iTraxx Crossover index of swaps on 50 European companies surged 44.2 basis to a mid-price of 576.2, according to Markit Group Ltd. The Markit CDX North America Investment Grade Index Series 14 declined 3.5 basis points to a mid-price of 117.2 as of 12:54 p.m. in New York, after rising 12.2 basis points yesterday, Markit data show.

The indexes typically rise as investor confidence deteriorates and fall as it improves.

German Ban

Credit-default swaps are derivatives that pay the buyer face value if a borrower -- a country or a company -- defaults. In exchange, the swap seller gets the underlying securities or the cash equivalent. A basis point on a credit-default swap contract protecting $10 million of debt from default for five years is equivalent to $1,000 a year.

To be covered by the ban, bonds must have been admitted on a German exchange for trading on the regulated market, BaFin spokeswoman **Anja Engelland** said in an interview today. Short selling of these securities is outlawed regardless where it is done, she said. Credit default swaps transactions are only covered if they are done within Germany, she said.

'Act Together'

Short sellers borrow assets and sell them, betting the price will fall and they'll be able to buy them later, return them to the lender and pocket the difference. In naked short- selling, traders never borrow the assets so betting is unlimited.

France, The Netherlands, Spain and Finland have no plans to implement similar measures. "We haven't envisioned doing it," French Finance Minister **Christine Lagarde** told reporters in Paris.

"It is important that member states act together and that we design a European regime to avoid regulatory arbitrage and fragmentation," the EU's Barnier said in an e-mailed statement.

European Commission President **Jose Manuel Barroso** said "we agree on the need to address the issue of abusive short selling."

The ban doesn't cover branches of German institutions outside of Germany or in the U.K., said U.K. Financial Services Authority spokesman **Joseph Eyre**. The FSA will assist BaFin, where appropriate, he said.

"It won't stop people sitting in Zurich or New York from shorting so it won't make a row of a beans difference to the ultimate outcome," said Lombard's Dumas. "It will make markets a lot less efficient and adjustment that much more painful."

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