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Special Report: Europe's debilitating deja vu

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How a host of divisions caused a seemingly unending string of setbacks to a deal for a new Greek bailout. First of three parts.

By Luke Baker, Paul Taylor and Dina Kyriakidou

(Reuters) - Greek Finance Minister Evangelos Venizelos came into office offering a fresh start in his nation's financial crisis. But he began with more of the same.

When the 54-year-old politician made his debut at an emergency meeting of euro zone finance ministers on June 19, his country was teetering on the brink of bankruptcy and desperate for more aid to avoid default. The burly constitutional lawyer began his presentation by seeking to renegotiate an austerity program his predecessor had only recently concluded with European Union and International Monetary Fund inspectors. Greece needed easier terms, he said.

"Venizelos started with excuses as to why they have to change some parts of the program to buy parliamentary support," said one participant in the confidential Sunday-night meeting in Luxembourg.

The euro zone's point man in the talks, a normally mild-mannered Finn named Olli Rehn, exploded. The EU's executive arm would refuse to sign off on Greece's compliance with its bailout program, the 49-year-old economic and monetary affairs commissioner told Venizelos. Athens would get no further emergency loans, Rehn said, according to the participant. "I will not put my signature to the compliance report on behalf of the Commission," Rehn said.

That moment of tension was one of many as European officials grappled to find a fix for Greece in the first weeks of summer -- a fix that several months on has failed to ease fears in a painfully protracted drama. Today, Greece has once again fallen behind on its fiscal targets. Its economy is heading for a fourth straight year of recession in 2012. Public anger over austerity, pay cuts and rising unemployment is boiling in the streets. And growing expectations of a Greek sovereign default threaten to unleash a banking crisis in Europe and aggravate a global economic slowdown. "The negative feedback loop between sovereigns and banks is materializing," said a senior EU official in the thick of the fire-fighting.

As the strains mount, the battles over politics and policy are sometimes turning personal. In months of round-the-clock crisis management, ministers and senior officials have grown physically exhausted and at times short-tempered with each other.

Many euro zone officials blame Greece's lack of engagement for the crisis. Others point to alleged intransigence on the part of Europe's most important political leader, German Chancellor Angela Merkel.

The incident marked the start of a long, hot summer for the 17 countries that tied their destinies together with the adoption of the single currency in 1999. To better understand how the second Greek bailout was reached -- and why a third bailout now looks almost inevitable -- Reuters spoke to dozens of ministers, officials, central bankers and other key players.

This report -- the first of three -- examines the drama that played out this summer, a period of just over a month between June 19 and July 21, when European leaders sealed a deal they hoped would put an end to the crisis. It did not.

What emerges is a picture of cultural differences among the euro zone countries, personality clashes among their leaders, denial in Greece about the extent of the problem and political paralysis that has threatened the economies not just of the euro zone but the rest of the world.

It raises questions about the future of the euro zone, whose diverse make-up and preference for compromise make speedy action almost impossible. Where a sovereign government can take swift action, the euro zone countries have held a series of meetings -- 18 so far -- without ending the crisis. Every twist and turn required tortuous negotiation. Every decision had to balance pressure from the richer and poorer nations, and from the markets and angry voters.

Like the Greek finance minister in June, it sometimes seems Europe is going over the same ground and fighting the same battles. Another day, another crisis. Another week, another summit. Another deal, another setback.

JUNE 19: A BAD FIRST IMPRESSION

The euro zone crisis is now two years old. In October 2009, the newly elected government of George Papandreou announced that Greece's budget deficit was close to 13 percent -- twice that previously advertised. In April 2010, with Athens teetering on the brink of bankruptcy, Greece's euro zone partners and the International Monetary Fund agreed a rescue package of 110 billion euros ($146 billion).

By May this year, as Europe battled to stop the Greek disease spreading, both Ireland and Portugal had received their own bailouts. But fears over Athens had never really faded. When the "troika" overseeing Greek implementation of the bailout plan -- the European Commission, the IMF and the European Central Bank – visited the country in February, it announced it had serious doubts about Athens' privatization plan and the speed of reforms.

With summer approaching, a second bailout package began to look inevitable. And now here was Greece's new finance minister wanting to undo agreements already settled.

Other ministers at the June 19 meeting piled in behind Finland's Rehn. The message: There would be no release of funds and no consideration of a second bailout package unless the Greek parliament approved the austerity program it agreed with the EU and IMF and implemented laws for economic reforms and sales of state assets.

"Venizelos made a bad first impression, but he is a quick learner," the participant said. "The next morning, he got on the phone to the president of parliament and said they had to use emergency procedure to push the privatizations through." The Greek finance ministry had no immediate comment on Wednesday.

JUNE 20-JULY 11: A LAUGHING STOCK

In the weeks that followed, Venizelos' education would seem like a minor hurdle in the campaign to save not just Greece but the euro zone itself.

By July 8, the Italian government's cost of borrowing had soared: Yields on 10-year Italian government bonds had risen to nearly 5.3 percent and the premium over German bonds hit 2.45 percentage points, the largest gap in the lifetime of the single currency. Italian share prices had fallen alarmingly. Trading was briefly suspended.

The markets were reassessing Italy and Spain as dangerously risky investments. The third and fourth largest economies in the euro zone were in danger of going the way of Greece, Ireland and Portugal. And they were too big to save with the EU's existing financial toolkit.

The 11-year-old single currency project, the most ambitious achievement in six decades of European integration, was threatening to unravel.

When the 17 euro zone finance ministers met again in Brussels on July 11, Italy seemed to be teetering. The southern European state has the largest debts in the euro zone, at 1.9 trillion euros -- 120 percent of gross domestic product. Market turbulence there was compounded by a political crisis. Prime Minister Silvio Berlusconi, who was on trial on charges of corporate corruption and paying for sex with a minor, was now publicly at loggerheads over budget cuts with his economy and finance minister, Giulio Tremonti.

It was nearly midnight when Rehn and the chairman of the euro zone's finance ministers group, Jean-Claude Juncker, sat down to report to the press corps on the outcome of the summit.

Juncker, a heavy-smoking 56-year-old who also serves as Luxembourg's prime minister, adjusted his glasses, cleared his throat and read very deliberately a six-paragraph statement that was long on generalities and short on specifics. There was silence as the 100 or so journalists parsed an announcement that had taken nearly eight hours to craft.

Then Rehn took the microphone and read the statement again, promising to "explore the modalities for financing a new multi-annual adjustment program" for Greece, among other fuzzy pledges.

A British journalist began to ask a question about the meaning of the statement but burst out laughing. The room laughed with him.

Rehn fixed the questioner with a cold stare, while Juncker tried to joke his way out of the situation. But the damage was done. The best efforts of the euro zone finance ministers to tackle Greece's debt predicament and hold their monetary union together had been reduced to a laughing stock.

JULY 12- JULY 15: MERKEL HOLDS OUT

A senior official involved in the negotiations described the news conference as the moment when the truth dawned on many in Europe: Perhaps the finance ministers wouldn't be able to find a solution.

France had a novice finance minister, Francois Baroin, replacing the respected Christine Lagarde, who had left to head the International Monetary Fund. Baroin was unfamiliar with crisis management and spoke almost no English, the lingua franca of the Eurogroup. Germany's veteran finance minister, Wolfgang Schaeuble, had meanwhile played down any pressure for an agreement, saying Greece was fully funded until September.

The following day a thicket of top European officials, including the head of the European Central Bank, met Rehn and Juncker to seek a common position. It was clear that market pressure was building for rapid, dramatic action.

"At that point, we realized the finance ministers weren't going to solve it, that it would take a special summit of euro zone leaders," the official said.

Herman Van Rompuy, the Belgian who leads the European Council of EU heads of state, declared that he was calling a summit on July 15. He hoped that setting a short deadline would force a deal on a second rescue package for Greece.

The only snag was Merkel. The German leader was on an official three-day visit to Kenya, Angola and Nigeria, following the women's world soccer cup back home avidly on her mobile telephone, and didn't see the need for an emergency summit.

In Merkel's eyes, the euro zone was locked in a "battle" with the markets, which were testing Europe's political will. She wanted to bolster confidence in the euro area. At the same time, Germany had to ensure that Europe maintained its economic competitiveness and sustained political support in member states where it was wavering, such as the Netherlands and Finland.

Before leaving Berlin, Merkel called Rome to insist Berlusconi calm the markets by approving the deficit-cutting package of Italian Finance Minister Tremonti, according to a senior adviser in the German chancellery. Other leaders, including van Rompuy, also called the Italian premier.

Berlusconi acquiesced. "The paradox is, that in the end Tremonti never had to fight less for a budget his whole life," the adviser said.

But by then the crisis had entered a more serious phase.

JULY 15 - JULY 20: GREECE SIDELINED

With Merkel insisting there could be no summit unless a real solution was close at hand, the markets panicked. Italian borrowing costs surged anew; Spain's rose even higher.

The German chancellor finally changed her mind after her finance minister, Schaeuble, argued that another summit was the only chance for a new deal.

"We knew that by setting a date for a summit, failure would not be an option -- something had to come out," a senior EU official involved in the negotiations said. "It was a risk, but it was the only way."

With the meeting set for July 21, Merkel enjoyed the final of the women's soccer world championship in Frankfurt, in which Japan beat the United States on penalties. Six days remained for senior advisers, so-called 'sherpas', to thrash out a deal. The bar was high: Any deal had to reconcile powerful private sector interests with German demands that banks and insurers help pay for a solution that would make Greece's 340-billion-euro debt pile more sustainable.

Although the crisis had its roots in Greece, Athens was barely consulted in the run up to the summit. The negotiation was mostly between Brussels, Berlin and Paris, with Jean-Claude Trichet, president of the Frankfurt-based European Central Bank, pulled in by telephone and eventually in person.

The sidelining of Greece reflected in part concerns that Papandreou was not fully engaged in the crisis. A senior EU source directly involved in the talks said the U.S.-born prime minister had long kept the troika of the European Commission, the IMF and the European Central Bank at arm's length.

"The troika never had access to Papandreou," the source said. "The negotiations took place with (previous finance minister) George Papaconstantinou and his team. When there was an issue that was outside his ministry's competence, the troika had to go to the relevant minister. Sometimes they were obstructive."

As progress in Greece slowed during the spring, Papandreou continued to remain outside the process. Eventually, it became clear he could no longer sit on his hands. He reshuffled his cabinet in June, shunting Papaconstantinou to the environment ministry in favor of Venizelos.

Papandreou's office declined an interview request. Aides say he is fully engaged in the crisis but prefers to work by consensus-building rather than issuing orders.

THE OPTIONS

Ahead of the July 21 summit, a critical issue loomed: the deal would have to involve private sector bondholders -- the large banks and insurance companies represented by the Institute of International Finance -- in a manner acceptable to EU power brokers France and Germany and to the European Central Bank. With bailouts deeply unpopular among voters, Berlin insisted banks share the pain. The ECB vehemently opposed any move that would trigger even a partial or temporary default.

The IIF itself discussed options for voluntary participation in a Greek rescue, according to a banking source. "There was a lot of brainstorming about what kinds of approach is going to be constructive and sufficient not to create market contagion," a person familiar with the talks said.

At the same time, senior euro zone treasury officials and ECB emissaries, known as the Eurogroup Working Group, tried to sculpt a deal that would stop the rot. They drew up three options, one pushed by Germany, two by the French.

The most costly plan centered on a German idea of a compulsory bond swap, in which Greek bonds held by banks would be swapped for new paper that would pay out later. The bailout fund, formally known as the European Financial Stability Facility, wouldn't be expanded. The downside was that it was likely to cause at least a "selective" or partial Greek default and possibly a full default.

The second option revolved around a proposal by French banks: creditors would agree to roll over maturing Greek bonds into new, longer-dated securities. Greece would get longer-maturity loans at a lower interest rate. The bailout fund would get more scope to fight contagion. This too was likely to cause a selective default.

The third option, favored by Paris, involved a tax on the financial sector to pay for a bond buy-back, and more flexibility for the bailout fund to grant longer-term loans at lower rates. This idea had the upside that it was the most likely route to avoid a selective default. Predictably, the banks vehemently opposed the scheme.

FRANCO-GERMAN DEALS

France and Germany have a long history of striking deals on the eve of European summits. More often than not, they get their way.

In part this reflects the sheer power of their economies, which together represent 50 percent of euro zone output. But it is also because France and Germany each lead two broad religious-cultural strands of postwar Europe: France's Catholic, statist, intellectual tradition and Germany's more Lutheran, market-based, pragmatic bent.

Merkel has been widely criticized for dragging her feet while the euro zone crisis worsened, but she faces tough domestic constraints in a country haunted by a history of hyperinflation.

French President Nicolas Sarkozy knew Merkel needed some serious wooing. French banks held the most Greek debt among foreign bondholders, and Paris was desperate to cling to its own triple-A credit rating. He, more than anyone, had an interest in ensuring the chancellor accepted a comprehensive plan.

Two men had been engaged in secretive discussions for several days, working with an ad hoc group of top euro zone officials to shape a politically and economically feasible plan: they were Sarkozy's top adviser, Xavier Musca, and one of Merkel's most-trusted confidants, Nikolaus Meyer-Landrut.

They had made some progress but reached an impasse. The French preferred the bank tax idea to any voluntary bank involvement, which was a must for the Germans. Irate German voters had to be shown that taxpayers were not alone in bailing out profligate euro zone states. Banks had to be seen to bear some of the cost.

Berlin was also reluctant to give the European Financial Stability Facility more flexibility to buy bonds in the open market, lend money to recapitalize banks or grant precautionary loans to countries before they were shut out of credit markets. It feared such moves would be voted down by the German parliament, or overruled in court.

JULY 19-20: SARKOZY WOOS MERKEL

Sarkozy tried to break the deadlock in phone calls to Merkel over the two days before the Thursday summit. But the chancellor was implacable. U.S. President Barack Obama, who had made timely phone calls to urge Merkel to act at key points throughout the crisis, placed a call to her on Tuesday evening.

The French leader decided to take the risk of flying to Berlin on the Wednesday evening to try to thrash it out with the chancellor face-to-face.

"Sarkozy went there at the right time," a senior EU source privy to the negotiations said. "The Germans had made this mental process but needed a last push."

The two met at the Chancellery and were all smiles and hugs for the cameras. Once inside, however, they and their top advisers immediately knuckled down to business. After barely an hour, the talks broke off. Both sides consulted separately. When they resumed, a compromise of sorts was put forward.

Sarkozy would relinquish the idea of a financial sector tax and accept the bond swap demanded by Germany. In return, Merkel would allow the European Financial Stability Facility greater flexibility to head off the threat of contagion if a Greek default was declared, and support costly measures to ensure Greek banks kept access to ECB funds. It was an amalgam of options 'a' and 'b', with other elements tacked on.

Merkel needed assurances from Trichet that the central bank could go along with it. The ECB chief was raised by phone. Eventually he took the last Lufthansa flight of the day from Frankfurt, arriving in Berlin just after 10 p.m.

German Finance Minister Schaeuble also joined the talks, but Sarkozy did not bother to involve his own finance minister, the newcomer Baroin. It took four more hours of negotiation after Trichet's arrival -- and further calls from Berlin to Brussels, The Hague and other capitals -- before a proposal was in place.

"Trichet came round to accepting the principle of a short, selective default once it was clear to him that Germany was prepared to accept a much broader role for the bailout fund and allow all the steps necessary to stop contagion," a member of the Eurogroup of finance ministers said of the agreement.

The deal would mean the first selective default in the history of the euro, the first in western Europe for more than four decades. And it would require changing the legal structures of the bailout fund once again, with the tricky problem of securing parliamentary approval in several euro zone states. But it also looked like it could square the circle of delivering private-sector involvement, making Greece's debts more sustainable, winning the ECB's stamp of approval and threading the needle of political backing across 17 states.

JULY 21: NO SPECTACULAR

While 56-year-old Sarkozy went for a run in Berlin's Tiergarten park early on Thursday morning, senior officials in Brussels were already hard at work drafting the bones of a summit communique for the leaders. It would have to be married up with the details emerging from the negotiations on precisely how banks and insurance companies would contribute.

The leaders met at noon on another overcast day in a damp Belgian summer. Over a working lunch, the debate focused on what Sarkozy and Merkel had come up with – their 'bullet points' having been converted into a two-page document.

Early opposition came from the Netherlands, Finland and Slovakia, whose prime ministers said their parliaments would not accept more changes to the bailout fund, particularly anything that gave it the ability to buy bonds on the secondary market. But with Berlin set, they eventually folded.

The leaders knew they had to bring interest rates for Greece down to a sustainable level and use all the instruments at their disposal to fight contagion. "Every elected person has to take into account the concerns of his or her electorate, but you also have to take into account the facts," said a person at the center of the seven-hour summit negotiation.

When Reuters published details of the draft agreement a few hours before the summit ended, the euro and European stocks immediately rallied. The risk premium for holding peripheral euro zone bonds fell sharply.

"We surprised the markets with the boldness of our decision," said the person involved in the negotiations. "We took bigger, more important decisions than people expected."

But questions soon surfaced. How far did the deal go to alleviate Greece's crushing debt burden of nearly 160 percent of GDP? Would the banks, funds and insurers take part in the planned bond swap and debt buy-back? Were the terms too favorable to them?

Ever pragmatic, Merkel said before the summit that one meeting would not end 21 months of sovereign debt turmoil. "Further steps will be necessary," she said. "There is not just one spectacular event which solves everything."

(Luke Baker reported from Brussels, Paul Taylor from Paris, Dina Kyriakidou from Athens; with additional reporting by Jan Strupczewski in Brussels, Andreas Rinke in Berlin, Philipp Halstrick and Ed Taylor and Paul Carrel in Frankfurt; Editing by Simon Robinson, Michael Williams and Sara Ledwith)