In Europe, big states offer to aid weak ones

Willingness grows to bend the rules in an economic crisis

By James Kanter

BRUSSELS: Could Europe's biggest economies be called upon to bail out the smaller, weaker ones?

European Union rules were specifically designed so that one country could not be held liable for the debts of another cash-strapped member. And the European Central Bank is prevented from paying the debts for laggard states.

News Analysis

But now even the German finance minister is raising the prospect of a rescue becoming necessary.

Should countries in the 16-nation euro zone face problems, "we would show our ability to act," the minister, Peer Steinbrück, told reporters in Berlin on Wednesday. That echoed comments he made a day earlier, when Steinbrück acknowledged there was no provision in the EU treaties for helping insolvent countries. "But in reality the other states would have to rescue those running into difficulty," he said during a speech in Düsseldorf.

Sharpening such concerns, the European Commission, the EU's executive arm, on Wednesday warned that budget deficits in several EU countries are ballooning to worrisome levels, as governments everywhere struggle to respond to the dual crises of wobbly banks and sinking economies.

Many economists insist that Europe remains far away from the outlook described by Steinbrück. Even so, his comments have underlined how seriously Germany — Europe's biggest economy and its traditional, though increasingly reluctant paymaster — was taking the dangers of a default, even if it were to occur in a smaller European economy.

"Up to now it was not clear if large countries were willing to step into the breach but Steinbrück's statement shows they are ready," said Giada Giani, an economist in London for Citigroup. "Steinbrück is effectively recognizing that a default in even a small country profoundly escalates the risk for the euro and the monetary union as a whole."

One of the possibilities that policy makers could consider would be to create a fund financed by some or all member states, or by a central institution like the European Investment Bank, that would be used to buy government debt in countries that are having troubles, she said.

Under EU rules, economists said, the European Central Bank is prohibited from buying bonds directly from nations to help them out of their difficulties.

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But Thomas Mayer, chief European economist in London for Deutsche Bank, said the ECB could skirt those rules by accepting as collateral bonds issued by countries in distress from banks that had bought them.

"It's forbidden for the ECB to pass on cash to member states or buy their bonds directly from them, but the bank is able to get cash indirectly to them by buying bonds under repurchase agreement in the secondary market," he said. "The consequence of this is an increase in the ECB's balance sheet and central bank money creation."

Because this eventually could lead to unacceptable inflationary pressure, Mayer said it could encourage countries to bail each other out instead.

The ECB does not make public what bonds it holds and that made it unclear which countries, if any, might already be receiving this form of indirect help. But Mayer said he thought some countries were.

Other economists said that they expected countries to continue being able to pay the interest on their sovereign debt, no matter how difficult that was becoming under the current circumstances.

"Yes it's painful, and the public will feel the effects of this in terms of higher taxation and lower levels of public services," said Gilles Moëc, an economist in London for Bank of America Merrill Lynch. But he said governments having difficulty finding buyers for their debt would probably raise the interest rates offered before turning to bailouts from their neighbors.

François Lenoir/Reuters

Joaquín Almunia, EU commissioner for monetary affairs, in Brussels on Wednesday.

Interest rates on 10-year Greek government bonds still are lower than they were at the beginning of monetary union, Moëc noted. And rates on government bonds across Europe were still far lower than they were during the early 1980s, when rates hit levels of around 15 percent in many countries.

Bilateral bailouts "are not a likely outcome for the foreseeable future," he said.

The warnings by the European Commission on Wednesday were made against the background of a continuing rocky economic environment in Europe.

Joaquín Almunia, the commissioner for EU monetary affairs, said that for those countries with deficits exceeding 3 percent of gross domestic product, the commission would start so-called excessive-deficit monitoring.

The commission also confirmed that the French budget gap would shoot to 4.4 percent of GDP in 2009, up from 3.2 percent in 2008, and it said that it would not return to under 3 percent until at least 2011, base government spending plans.

The commission added that the German 2009 budget gap would be percent of GDP but rise to 4 percent 2010 and would be unlikely return t under 3 percent until at least 2012.

But Almunia also suggested he would take into account the econor circumstances and be flexible in seeking redress.

Before the onset of the financial crisis, nations that exceeded sound budget rules were given a year to get back in line, or face the prospect of sanctions.

Almunia's comments suggested tha this time he would exercise far greate flexibility and allow countries more than a year to patch up their finances.

"Nobody is thinking of sanctions," he said. The stimulus measures being taken by governments now were generally "timely, targeted and temporary," Almunia said.

But Steinbrück's comments seemed to underscore mounting investor concerns as some European nations pile on debt to bail out banks and counter what looks to be the deepest recession since World War II. One of the most tangible results has been a fall in the value of the euro against the dollar in recent weeks.

While declining to identify countries facing problems, the Germa finance chief said Ireland, which has widening budget deficit, is in a "very difficult situation."