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Merkel's great gamble on euro zone crisis

BERLIN

How Germany emerged as lender of last resort in economic muddle

BY STEVEN ERLANGER

Angela Merkel, the German chancellor, decided she'd had enough — enough of being dragged behind the euro crisis like a tin can caught in the wheels of a careening car; enough of being forced, in late night crisis meetings, to put German money and financial guarantees on the table; enough of being blamed for reacting too slowly, too cautiously, too stiffly. And most of all, enough of being caught between the demands of European solidarity and her own skeptical, anxious public, which accused her of giving away their money.

It was late October, senior German officials said, when the Irish collapse forced Mrs. Merkel to realize that it was not enough just to blame reckless Greeks for Europe's financial traumas.

The growing support for solving the crisis on the back of Germany — especially with a "Eurobond," a collective instrument to Europeanize debt, helping profligate countries and seemingly punishing the virtuous ones — also drove her to try to reframe the argument in a way Germans would bear.

It is a major gamble for Mrs. Merkel, and for Germany. Berlin is stepping forward to try to impose its will, with French editing and support, on the rest of the European Union, and it's not always a pretty sight.

But if the euro is to be saved and a solution found for the imbalances in the 17-nation euro zone, Germany must be the lender of last resort. For that, the Germans have a price.

A meeting of the leaders of the 17 euro zone countries on Friday in Brussels will be a key indicator about whether Germany and Mrs. Merkel can pull off her great gamble. The meeting will prepare for a full European Union summit on March 24-25, which is supposed to set the seal on a long-term solution to the European economic crisis.

Whether it will remains an open question, particularly since the latest proposals do not directly deal with the vulnerability of many European banks and postpone restructuring of the sovereign debt of the weakest countries.

But faced with renewed nervousness in the markets, and financial turmoil that has resisted every emergency fix, European leaders are mulling a radical reinvention of government that would

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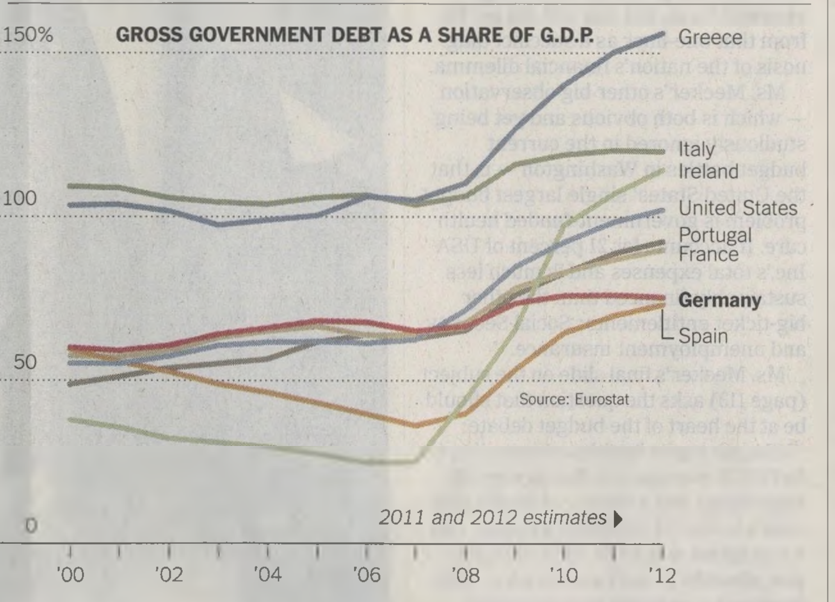

Markets shiver as E.U. gathers for summit

BRUSSELS

Little confidence remains that definitive steps will be taken to end turmoil

BY STEPHEN CASTLE AND RAPHAEL MINDER

Stock markets and the euro dropped Thursday as investors registered worries that a meeting of leaders of the 17 euro zone nations Friday would not pave the way for a decisive step to end their debt crisis.

The meeting comes amid renewed concerns about countries on the periphery of the zone. Such concerns were underlined Thursday when Spain's sovereign debt rating was downgraded by Moody's. The credit rating agency forecast that the cost of recapitalizing Spain's ailing banks would be at least twice the €20 billion upper limit, about $28 billion, predicted last month by Spain's government and its central bank.

Later in the day, however, the Bank of Spain reaffirmed its more optimistic assessment by releasing a new study of the banking sector that put the overall cost of recapitalizing the country's weakest institutions at €15.15 billion.

Still, analysts warned that the financing problems of the euro zone's periphery countries, coupled with a recent warning from the European Central Bank about raising interest rates, made it essential for European Union leaders to agree this month on stronger emergency financing measures should further debt-related problems hit the euro zone.

"We're now seeing that the market optimism at the beginning of the year was misplaced," said Chiara Cremonesi, a fixed-income strategist at UniCredit in London, "because the problems of the periphery countries are still there and we are in fact a long way away from their solution. In this respect, the E.U. summit at the end of March will be key."

U.S. and European stock markets all weakened Thursday, with the Dow Jones industrial index down 1.7 percent in late afternoon trading. The pan-European Euro Stoxx 50 closed down 0.9 percent, the FTSE 100 in London shed 1.6 percent and the French and German indexes both lost nearly one percent. The euro, meanwhile, dropped 0.8 percent to $1.38.

E.U. leaders were expected to agree Friday on a new pact, demanded by Germany and France, designed to inject more discipline into the currency zone by dealing with issues ranging from raising retirement ages to adopting debt brakes. Once approved by the 17 euro zone countries, the 10 remaining E.U. members outside the euro zone would be invited to join.

Berlin considers a deal on the "pact for competitiveness" a precondition for bolstering the €440 billion backstop fund for euro zone countries and making it permanent, and possibly more flexible,

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BRITAIN KEEPS INTEREST RATE LOW
The Bank of England, more fearful of a weak economy than inflation, left its main rate unchanged Thursday. PAGE 16

Spying case proving to be a bane for Renault

PARIS

Hedging claims of proof, carmaker is bracing for executive suite shake-up

BY DAVID JOLLY

The extraordinary charges shook the French business establishment: Renault, the automaker, said in January that three of its employees had been caught trying to sell its electric car secrets overseas. So confident was the company of its case that it fired the three and filed criminal charges. Carlos Ghosn, the chief executive, went on television saying he had seen proof of the men's guilt.

But the affair appears to have turned from the sensational to the farcical — and now threatens to become a tragedy. Renault is climbing down from its accusations amid doubts about key evidence, creating a possibility that heads will roll amid deep embarrassment in the French establishment.

Like BP, which found its corporate image splattered by the Gulf of Mexico oil spill last year, Renault may soon be looking for new people for its executive suite. Finance Minister Christine Lagarde of France has pointedly called on management to "take all the consequences" in the case.

The investigation is not over yet, and new evidence could still turn up to implicate the men. But Renault no longer talks of certainty. Patrick Pélata, the chief operating officer, on Wednesday told the French daily Le Figaro that "a certain number of factors lead us to doubt" the previous assertions.

At issue is the evidence on which the charges rest: The Swiss and Liechtenstein bank accounts the men were alleged to have created to channel the wages of spying have not been found, even though a secret source had sup-

RENAULT, PAGE 17

TARA TODRAS-WHITEHILL/THE ASSOCIATED PRESS

Pulling back Libyan opposition members grieved during clashes Thursday with government loyalists near Ras Lanuf. Rebels fled the area under heavy attacks. PAGE 4

West struggles to find unified voice on Libyan violence

France recognizes rebels as sovereign, but NATO holds back on using force

BY BRIAN KNOWLTON

As the Libyan government neared perhaps its most significant military victory since insurrection erupted almost a month ago, Western leaders struggled Thursday for elusive accord on how to quell violence and slow the momentum of loyalist forces fighting for Col. Muammar el-Qaddafi.

Although France took the bold step of recognizing Libya's insurgents as a sovereign force, NATO defense ministers at a crisis meeting in Brussels held back from any military intervention and agreed only to reposition ships in the region and to continue planning for humanitarian aid.

There was no agreement on imposing a no-flight zone, an approach dividing even normally close European allies. Separately, both American and Russian officials issued pointed warnings about the dangers of such a step.

After days of battles, rebel fighters fled the strategic refinery town of Ras Lanuf on Thursday under ferocious rocket attacks and airstrikes by forces loyal to Colonel Qaddafi. As they scrambled, they cursed the United States and its allies for failing to impose a no-flight zone. Their retreat dashed bold plans of a westward drive to Tripoli by the undermanned and ill-equipped rebel army.

Despite Western hesitancy on military action, there was a flurry of diplomatic activity spanning three continents. Both the Qaddafi government

LIBYA, PAGE 4

QADDAFI SHIELDED BY HIDDEN CASH
The Libyan leader, Col. Muammar el-Qaddafi, is said to have "tens of billions" in cash hidden away. PAGE 4

EGYPT'S SECURITY INTRUSIONS EXPOSED
Government files recovered in Cairo provide insight into the extensive reach of Egyptian state security. PAGE 5

AT A LIBYAN HOSPITAL, THE COST OF REVOLT
Ajdabiya Hospital offers a narrative of the popular revolt: the willingness to see a country through this trial. PAGE 5

CARLOS JAVIER ORTIZ/EUROPEAN PRESSPHOTO AGENCY

WORLD NEWS

Wisconsin protest A demonstrator was removed on Thursday in the state Capitol as lawmakers were one vote away from dismantling union rights. PAGE 6

Dalai Lama ceding political role
The decision is intended to strengthen the democratic structure of the Tibetan movement, analysts say. PAGE 2

Karzai cousin killed in raid
The issue of civilian casualties touched the presidential palace as Hamid Karzai lost a family member. PAGE 6

BUSINESS

Obama's energy goals draw fire
A House panel voted Thursday to strip the Environmental Protection Agency of its power to regulate greenhouse gases, chipping away at one of the pillars of the Obama administration's climate and energy strategy. The sharply partisan voice vote undercut the administration's already diluted efforts. PAGE 17

A succession plan at Sony?
Sony said Thursday that it had promoted its video games chief, Kazuo Hirai, to oversee a new unit combining cameras, televisions and other consumer electronics, paving the way for him as a potential successor to Howard Stringer as chief executive. PAGE 16

Nokia's engineers get an offer
In a bold move to revive its struggling smartphone business, Samsung Electronics is trying to lure engineers from Nokia, the Finnish company that plans to abandon its proprietary mobile operating system and lay off perhaps thousands of employees. PAGE 17

VIEWS

Celestial storm warnings
Space weather, from solar flares to shimmering aurora, can affect human safety and economies anywhere on our vast, wired planet, write John P. Holdren and John Beddington. PAGE 8

Libya calling
The Libyan author Hisham Matar writes of receiving long-distance telephone updates from his relatives, who are fighting in the uprising. PAGE 8

COMING THIS WEEKEND

Geneva's worldly challenge
A tussle encapsulating the tensions between the city's international aspirations and local realities is playing out in microcosm at a prime real estate site in the city.

The architect's architect
Peter Zumthor's work is more laborious than flashy. But he has designed some of the subtlest and most admired buildings of the last quarter-century.

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CURRENCIES NEW YORK, THURSDAY 1:30PM

			PREVIOUS
▼ Euro	€1=	$1.3810	$1.3910
▼ Pound	£1=	$1.6050	$1.6200
▲ Yen	$1=	¥82.980	¥82.730
▲ S. Franc	$1=	SF0.9330	SF0.9300

Full currency rates Page 19

STOCK INDEXES THURSDAY

▼ The Dow 1:30pm	12,056.73	-1.28%
▼ FTSE 100 close	5,845.29	-1.55%
▼ Nikkei 225 close	10,434.38	-1.46%

OIL NEW YORK, THURSDAY 1:30PM

▼ Light sweet crude	$101.73	-$2.58

News

ERIC FEFERBERG / AGENCE FRANCE-PRESSE

Chancellor Angela Merkel of Germany with, from left, the E.U. Central Bank president, Jean-Claude Trichet; the European Commission chief, José Manuel Barroso; Prime Minister George A. Papandreou of Greece; and President Nicolas Sarkozy of France. Leaders are seeking a lasting solution to the debt crisis and a reduction of deep economic imbalances.

Merkel's great gamble on the euro zone crisis

GERMANY, FROM PAGE 1

go far to harmonize sovereign economic policies, and in the longer run, limit many of the wage and welfare benefits that have defined Europe's politics.

The goal is to find a lasting solution to debt crisis and reduce the deep economic imbalances between northern countries like Germany and southern ones like Portugal, Greece and Spain. That will require much greater budget scrutiny and a longer-term commitment to structural change in southern nations to make them competitive.

Germany has traditionally taken a back seat in Europe, reluctant to impose its will on others. Mrs. Merkel did not particularly want to lead Europe out of the euro mess, aides say. She simply decided she had no choice but to try.

''We had the feeling we were always behind the crisis,'' said a senior German official, who was not authorized to speak on the record.

Jörg Asmussen, deputy finance minister under Wolfgang Schäuble, said politics were key. ''We had a clear, growing sense that we were having difficulties with our people, to say after yet another long weekend in Brussels, 'We want this or that from you,''' he said. ''So we wanted to try for a comprehensive deal.''

But there was also a commitment to European solidarity, said the first official: ''Merkel and Schäuble understand that history will judge them on how they dealt with the sovereign-debt crisis in Europe.''

SOMETHING TO SHOW VOTERS

Mrs. Merkel doesn't have Europe in her veins, as the French-speaking Mr. Schäuble does. And she has an increasingly narrow space within which to work, with a weak coalition partner, the liberal Free Democrats, playing a strong euroskeptic line, and three key state elections looming this month.

''The harsh domestic debate in Germany has shaped the policy,'' said Daniela Schwarzer, a political economist at the German Institute for International and Security Affairs. ''Even her own coalition wants to put parliamentary limits on her, so she had to show that Germany is not just paying but framing the debate and setting the rules.''

Negotiations in the run-up to Friday's meeting have been difficult; markets are getting nervous again about Greece, Ireland, Portugal and Spain; some German ideas have been watered down. European officials say Mrs. Merkel is unwilling to take the risks now that she contemplated even two months ago, like tougher bank stress tests, a restructuring of Greek debt or even lower interest rates for loans to Ireland and Greece.

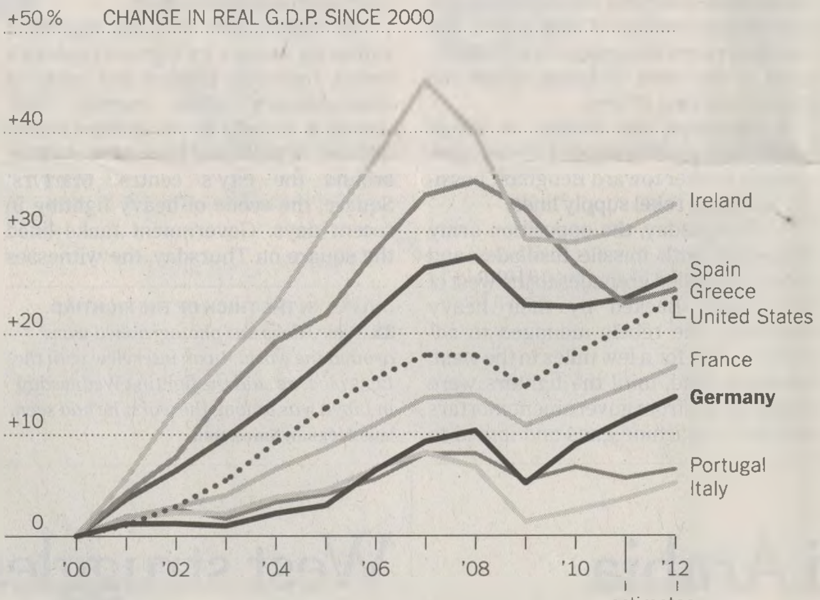
But all agree that Mrs. Merkel must emerge with something to show voters — especially with a state election in Saxony-Anhalt on March 20 and a vital election in Baden-Württemberg on March 27, just two days after the E.U. summit meeting. (Rhineland-Palatinate votes that day too, but less crucially.)

She must show by then, a senior French official said, that German willingness to put more money on the table for weaker countries is reciprocated by binding commitments from euro zone members to cut debt and more closely harmonize financial, economic and social policies. Both German and French officials agree that the German position is hardening, with the chancellery, mindful of the politics, pushing for a tougher deal than the Finance Ministry.

Werner Hoyer, a Free Democrat and deputy foreign minister in charge of Europe, said: ''We have to have a permanent mechanism that will be based on the 'last resort' idea, meaning that everybody is in charge of his or her own debt.''

The hare and the tortoise

With the advent of the euro a decade ago, several countries on Europe's periphery took advantage of low interest rates to race ahead. But now that their economies have collapsed they are expected to struggle to keep up with the more measured growth of Germany and France.



Source: Eurostat

A "PERMANENT REGIME"

For Mrs. Merkel, the solution is a bailout fund for euro zone governments in trouble now and in the future — but one that requires structural changes from laggards, penalties for the profligate and, ultimately, no free pass for private lenders.

To get this done, the Germans needed the French, and that meant giving President Nicolas Sarkozy something France has long wanted and Berlin had resisted — a form of ''economic governance'' of the euro zone dominated by the heads of state, rather than by the larger 27-nation European Union and its Brussels bureaucracy.

At meetings between Mr. Sarkozy and Mrs. Merkel at Deauville in October and Freiburg in December, plans were laid.

"There's a common understanding that we need to help Merkel get something that looks like a victory."

After that, a key meeting took place on a Friday night, Jan. 7, between the German and French finance ministers, Mr. Schäuble and Christine Lagarde, in a gorgeous room in the Bas-Rhin prefecture in Strasbourg, a half-hour drive from Mr. Schäuble's home.

''There, the road map was outlined,'' a German official said.

A French official elaborated: ''Both countries and ministers expressed very candidly and comprehensively their goals, limits and red lines on every subject on the table. It went on a long time, but we're still pretty much on that road map.''

Since November, the Germans have been negotiating regularly with Brussels and more intimately — in English — with the French, with whom they have an extraordinarily close relationship. They have been working on at least three levels for a comprehensive package.

The most important is a ''permanent regime'' — the so-called European Stability Mechanism, which will replace the temporary bail-out fund called the European Financial Stability Facility, set up in a hurry during the Greek crisis last May. That facility ends in June 2013, and the Germans see a permanent fund of perhaps €500 billion, or $690 billion, to show the markets that the euro zone is prepared for future problems.

But that fund must also show German voters that taxpayers will not bail out private investors, that no country will assume another's debts, that collateral will be offered and penalties imposed for bad behavior.

The second level is problems like Greece and Ireland, and whether those countries can ever repay their debts. Part of that debate is whether the €440 billion temporary facility will be strengthened to allow it to lend the entire amount, which would make it possible to cover Spain, and whether loans to Greece and Ireland can be extended or reissued at lower interest rates.

The third level has gotten the most attention, which is the ''Pact for Competitiveness,'' a name chosen for German ears, officials concede, but that rings badly in the rest of Europe.

The intention was to lay down specific commitments to coordinate economies — a common base for corporate taxes, the most contentious proposal, or for retirement ages — in order to keep spending in line with receipts. Indexing wages to keep up with inflation was to be banned and high deficits punished.

But when the pact was first broached at European level last month, leaders who had not been consulted were angry, and the French let Berlin take the heat. In the end, the joke went, the pact wasn't a pact, it wasn't German and it wasn't about competitiveness, but about fiscal health. And while it might help in the future, it would do nothing to solve the current problems of Greece, Ireland and Portugal.

SOME ISSUES LEFT UNADDRESSED

Perhaps the biggest problem of all, critics point out, is that the pact does not deal with a looming problem for Germany and the euro zone — huge private debt and shaky banks, including some German state banks. Berlin has resisted serious stress tests of its banks, and no politician in Europe is prepared to talk about any future bailout of banks that may be necessary if Greek and Irish sovereign debt are ever to be written down to manageable levels.

Still, on Friday, the euro zone leaders are expected to approve a watered-down pact that eliminates fixed pension ages and wage-indexation and gives states more latitude to reach objectives. Monitoring of the pact is left unclear. The main fight is about whether and how to align corporate tax systems.

German officials say that the commitments in the pact are important — that retirement ages and benefit systems should be adjusted to fiscal and demographic realities, and that each country find a way to make debt limits binding, much as Berlin has passed a constitutional amendment to eliminate the structural deficit by 2016.

Berlin is insisting that all three levels represent a package, and that there will be no increase, even in the temporary bailout facility, without an overall deal.

''There's a common understanding that we need to help Merkel get something that looks like a victory,'' said a senior E.U. official. ''And for the markets, we need to end March with a comprehensive approach and a permanent mechanism.''

But it will still be a difficult domestic sell for Mrs. Merkel. By the end of the month, another senior European Union official said, ''Merkel will have to swallow'' an increase in the temporary fund to allow it to lend fully; a non-German as head of the European Central Bank, possibly the Italian central banker and economist, Mario Draghi; and a two-sentence change in the Lisbon Treaty that will not produce the binding criteria and penalties Berlin wanted to reinforce fiscal discipline.

BUT WILL IT WORK?

Worst of all, experts say, the euro crisis will almost certainly not be over.

''The result will be a watered-down package that won't change a lot and won't end the crisis,'' Henrik Enderlein, a political economist at the Hertie School of Governance in Berlin. ''There seems to be a feeling in the chancellery that we don't have to take such big political risks if the fire is not burning in the same way as before.''

Mr. Enderlein believes that Mrs. Merkel is again being too cautious and risk-averse, misjudging the markets.

Jean Pisani-Ferry, the director of Bruegel, an economic research institution based in Brussels, said that he was ''not wildly optimistic, but I wish that the necessary things are done and quickly, because the markets get disappointed and the costs go up.''

At a minimum this month, he said, there has to be ''agreement on the permanent regime, on the rules of the game'' and on credible stress tests for banks, with recapitalization as necessary.

But soon, he said, Europe will be forced to recognize that, at a minimum, Greece must restructure its debt. And for the next five years, he said, there must be an intense effort to improve competitiveness in the euro zone, to help lagging southern Europe liberalize economies and labor markets to reduce manufacturing costs and produce growth.

''Even if we do all the right things, how fast will southern Europe catch up?'' Mr. Pisani-Ferry asked. ''Because it must. If not, these countries will find themselves in permanent unemployment and not growing, and then you will need real transfers to keep the euro zone together.''

Reporting was contributed by Stephen Castle in Brussels, Judy Dempsey in Berlin and Jack Ewing in Frankfurt.

Markets shiver as E.U. gathers

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at another meeting on March 24.

But after a rebellion by smaller countries, the initial French-German plan for the pact has been softened, leaving only one contentious issue: Bringing corporate tax systems closer together.

Without tough and binding commitments to tackle structural problems across the euro zone, the German government will find it more difficult to persuade its public that it is right to increase the bailout fund or to allow it to be used more flexibly.

Moody's on Thursday reduced Spain's rating by one notch, to Aa2. The credit rating agency estimated the recapitalization needs of Spanish banks at €40 billion to €50 billion, adding that the amount could rise to as high as €120 billion "in a more stressed scenario." It also highlighted the recent failure by nine of Spain's 17 regions to meet their 2010 deficit targets, arguing that "this casts doubts over the ability of the central government to exercise sufficient control over the regions to ensure compliance with deficit targets."

In response to Moody's gloomy evaluation of the banking sector, José Luis Rodríguez Zapatero, the Spanish prime minister, said that it was the central bank that had the "information and credibility" to evaluate the needs of the banks.

Pablo Vázquez, an economist at the Fundación de Estudios de Economía Aplicada in Madrid, also described Moody's cut as surprising, given the government's recent fiscal consolidation progress. Concerning Moody's assessment of the banking sector, he added that even a €40 billion recapitalization was "perfectly manageable for any economy."

Meanwhile, Portugal's borrowing costs for two-year debt hit new highs Wednesday as investors in a bond auction showed fresh concern about the country's economy and political fragility. Greece and Ireland, the two euro zone countries that have so far received emergency E.U. financing, also are facing renewed financing pressure.

The latest version of the E.U. proposals says that countries should announce commitments to improve several aspects of economic performance within 12 months. These targets should be announced on March 24 if possible or, for countries unable to do so, in June. But by giving countries the ability to choose the details of their own measures, the latest draft has made it difficult to use the agreement as a vehicle to impose rigid, Germanic fiscal discipline on the euro zone. "It's not worth the paper it's written on," said an E.U. official speaking on condition of anonymity.

The latest paper softens the sense of obligation on governments by referring to a "set of possible measures," and it weakens a passage that, in earlier drafts, called for a review of wage-setting arrangements to end indexation. This followed objections from countries including Belgium.

Moves to align retirement ages will take demographic factors into account, something that would help French workers to continue to retire earlier than Germans.

The new draft also makes concessions following other objections raised in recent weeks. It stresses the role of "social partners," like unions, and of existing E.U. institutions in an effort to reassure those who feared that bodies, including the European Commission, the bloc's executive arm, or the E.U. Parliament would be bypassed.

The language also seeks to highlight the significance of the pact to citizens.