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# Markets let E.U. leaders know time is running out

PARIS

## Spain and Italy face spike in interest rates after failure of Greek bailout

BY STEVEN ERLANGER AND RACHEL DONADIO

Confronted by the failure of their earlier rescue of Greece and new strains on the significantly larger economies of Italy and Spain, European leaders will once again convene an emergency summit meeting Thursday to deal with another Greek bailout and the enduring crisis of the euro.

Hopes have proved illusory that a forced austerity would allow Greece to turn around, and there is a new comprehension that Greece is insolvent and that its rising debt burden must be cut. But while European leaders debate what to do, and how to involve the private sector in the pain, the European Central Bank still insists on a response that will not be considered a default.

There is a game of political and financial chicken going on, but the markets seem to be becoming fed up with the uncertainty. Sharply higher interest rates on the debts of Italy and Spain are sending a clear message to politicians and the European Central Bank to make the difficult decisions required to reduce the mountain of Greek debt, analysts say; otherwise, confusion about the euro could further harm Italy and Spain, which are considered too big to bail out.

''For Spain and Italy, you need to provide a solution for Greece, plus a safety net to prevent contagion,'' said Antonio García Pascual, chief Southern European economist for Barclays Capital. ''But the inaction of policy makers is unhelpful. And we don't have weeks; it's a matter of days, especially with Italian and Spanish bonds at this level.''

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# Markets put pressure on Spain and Italy as politicians debate Greek debt

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fourth-largest economies in the euro zone, after those of Germany and France. Italy alone has debt of 120 percent of its annual gross domestic product and must refinance nearly a quarter of it, nearly €400 billion, or $565 billion, in the next 18 months. That figure alone is larger than all of Greece's estimated debt of about €340 billion, and at suddenly spiking interest rates of 6 percent or so, even Italy would be teetering toward insolvency.

Officials involved in talks on the new Greek rescue package said that in recent days the debate had moved beyond Greece and that markets were now questioning the very architecture of the euro. They said the real issue that would be on the table Thursday is whether European leaders will show a political commitment to keeping the euro viable.

At a minimum, Greece needs another €115 billion to cover its borrowing needs through mid-2014 in addition to the €110 billion the European Union and International Monetary Fund agreed to provide last year.

"The game-changer is the threat to Italy, which is too big to handle," said Jean Pisani-Ferry, the director of Bruegel, an economic research institute in Brussels. "It's not any longer just Greece plus the two small ones, Portugal and Ireland, and a remote risk for Spain. Now Spain and Italy are in play. There is a small problem, which is Greece, and this is the last opportunity to show that by addressing the small one you can address the larger ones."

Until recently, the argument was that any Greek restructuring or default would create a market frenzy aimed at other countries in difficulty. But the failure to cope with the reality of Greek insolvency has had the opposite effect, causing more contagion.

"To see those yields on highly developed countries like Italy jump so fast has really focused minds," said Simon Tilford, chief economist for the Center for European Reform in London.

Chancellor Angela Merkel of Germany has insisted that there is little urgency and that the private sector must be involved in any restructuring.

"Merkel is now in a very difficult position," Mr. Tilford said. "The Germans are now alive to the risk in ways they weren't before. For all the derision about Silvio Berlusconi, Italy is core Europe and has very strong ties to Germany and France."

But as ever, those pressing for a comprehensive solution may be disappointed, with Mrs. Merkel saying Tuesday that "a spectacular, single step cannot responsibly be made, including on Thursday." Instead, she said, "we need a controlled and manageable process of successive steps and measures" for "reducing debt and improving competitiveness."

European technocrats are reportedly exploring a tax on euro zone banks to cover burden-sharing by the private sector, and a supposedly voluntary "rollover" of existing bonds for ones with a lower interest rate and a much longer maturity to preserve the face value of the bond. That idea, originally French, might not be judged a "default" by all ratings agencies.

KOSTAS TSIRONIS/BLOOMBERG

**Evangelos Venizelos raised eyebrows by speaking of a Greek "selective default."**

For 18 months, as the Greek government struggled to push through austerity measures, the word "default" was taboo. But last Thursday, the Greek finance minister, Evangelos Venizelos, for the first time openly discussed the prospect of a "selective default" in Parliament.

Finance Ministry officials insisted that "selective default" was simply a rating-agency term for any plan that includes the private sector; the opposition immediately accused the government of trying to bankrupt the country.

But Mr. Venizelos's statement opened a new chapter, a recognition that Greece is insolvent and that time has run out.

"Reaching a solution is attainable because this solution does not only include Greece," Mr. Venizelos told The Associated Press on Tuesday. "At issue is the euro and the resilience of the euro zone."

Few think Greece can avoid some form of default. "The point of departure cannot be any more to insist on Greece repaying full maturity on the bonds it owns," said Jens Bastian, a German economist at the Hellenic Foundation for European and Foreign Policy in Athens. "Some call it a selective default, some call it a rollover, some call it a debt exchange, some call it a reprofiling. But obviously no one in their right mind accepts that Greece is going to repay on time in full."

Jean-Claude Trichet, president of the European Central Bank, has been adamant that he will not accept any kind of default or "credit event" over Greece, that all obligations of a euro zone member must be met or the markets will attack every highly indebted country in turn. But that is happening anyway, and few believe that he is under any illusion about Greece.

What he and the bank want, analysts say, is a comprehensive solution that protects the bank's balance sheet from a markdown in Greek debt and recapitalizes other banks, inevitably with public money.

"If you cut the Greek debt by 50 percent you have to rebalance the E.C.B. balance sheet, since it has loaned so much to national banks to buy national debt," Mr. Tilford said. "They're saying that if you restructure, you need public money to recapitalize the banks and restore the E.C.B. balance sheet."

But the need to inject more public money is exactly what Germany and its allies, like the Netherlands, do not want to do, because critics will charge that recapitalization would represent a "transfer" of funds to undeserving countries.

"The E.C.B. isn't saying 'no restructuring'; in private it's saying you have to address these other issues in conjunction, and unless the E.C.B. has cast-iron assurances that the difficult political decisions will be made, their position will remain as it is," Mr. Tilford said.

Mr. García Pascual said default required an "adequate safety net and firebreaks," including the ability of a larger European Financial Stability Fund, set up to help Greece, Portugal and Ireland, to buy sovereign bonds in the secondary market — in other words, from the European Central Bank itself. "If the fund can be more flexible, it could buy the E.C.B. out of its positions, and that can change the game."

The central bank might then feel easier about relaxing some of its rules about collateral to aid banks in peripheral countries.

But so far, Berlin has rejected the idea of giving the fund the ability to buy bonds in the secondary market, and it has also rejected the idea of a "Eurobond" guaranteed by all the countries of the euro zone, arguing that this idea, too, puts German taxpayers at risk and would raise Berlin's borrowing costs.

"The market is far more intelligent and resilient than a lot of politicians realize," said Lee C. Buchheit, a lawyer with Cleary Gottlieb Steen & Hamilton in New York who has handled sovereign defaults. "Investors realize that sometimes you make money and sometimes you don't. But they can't abide prolonged uncertainty."

*Rachel Donadio reported from Rome.*