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Euro zone fumbles on halting crisis

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INSIDE EUROPE

PARIS The European Central Bank waved its big fire hose at blazing bond markets, then turned on a puny sprinkler.

Unsurprisingly, the fire refused to go out. Indeed, the flames grew higher, licking the feet of Italy and Spain, the currency area's third- and fourth-largest economies, after Germany and France.

Three days later, the bank's governing council decided in an emergency Sunday night conference call to change course abruptly and resort to the big fire hose after all.

The E.C.B. may now become the reluctant owner of tens of billions of euros in Italian and Spanish debt in a high-risk strategy to avert a European financial meltdown.

It was not the first time since the euro zone's sovereign debt troubles began in late 2009 that the guardians of the European common currency had been forced by events into a U-turn.

The hesitant response to the latest and most dangerous turn in the crisis illustrates how political constraints are making it ever harder for Europe to find effective solutions. The 17-country euro zone lacks a lender of last resort, and its politicians and central bankers continue to argue over who, if anyone, should play that role.

European leaders thought they had erected a firewall at a July 21 emergency meeting by agreeing on a second bailout for Greece, the weakest link in the euro chain, and approving new steps to prevent contagion to other countries.

Yet after a 24-hour relief rally, investors gave the deal the thumbs down, judging it insufficient to stop the rot and spying a window of vulnerability before the measures took effect.

Faced with a big sell-off of Italian and Spanish debt that was forcing those countries' borrowing costs up toward unsustainable levels, the E.C.B. decided last Thursday to buy small amounts of Irish and Portuguese bonds only.

There were three possible reasons for the strange decision, which the E.C.B. president, Jean-Claude Trichet, communicated without his usual assurance:

- A dissenting minority on the bank's governing council opposed to any bond-buying has grown from one last year to four of the 23 members last week, E.C.B. sources say.
- Most E.C.B. policy makers thought Italy needed to do much more to put its public finances in order and liberalize its sclerotic economy before it deserved any support.
- And anyway, the European Central Bank wanted euro zone governments to take over the burden of buying risky bonds with their own rescue fund, the E.F.S.F., which some at the E.C.B. say central bankers believe should be at least doubled in size to fit the purpose.

By deciding on a half measure, the E.C.B. deliberately or accidentally heightened bond market pressure on Rome and Madrid. The downgrading of the United States' credit rating last Friday did the rest.

MARIO VEDDER/AP

Jean-Claude Trichet was less assured than usual in explaining the E.C.B.'s actions.

Without decisive action by the central bank, the euro zone crisis was set to spiral out of control Monday morning, E.U. officials agreed in frantic weekend telephone consultations.

Under fierce pressure from his European peers, Prime Minister Silvio Berlusconi of Italy agreed hastily Friday to bring budget-balancing measures forward by a year to 2013.

He also pledged to anchor a balanced-budget rule in the Constitution and to push through long-deferred changes in the welfare system and labor markets after talks with trade unions and employers.

Some central bankers hoped that leaving Italy to twist in the wind a bit longer at the mercy of bond market vigilantes would concentrate minds in Rome on finally breaking the habits of a lifetime.

That was before Standard & Poor's lobbed a hand grenade into the markets Friday by downgrading the United States' AAA credit rating to AA+ with a negative outlook, sending perhaps the strongest tremors around the global financial system since the 2008 collapse of Lehman Brothers.

The E.C.B. has now been forced into a major commitment, which it insists is temporary, to buy Italian and Spanish bonds to try to stabilize markets.

Euro zone leaders agreed last month to allow their €440 billion, or $623 billion, European Financial Stability Facility to buy bonds on the secondary market under strict conditions and to give precautionary loans to countries in difficulty.

But those new powers will not apply until national parliaments approve the changes, probably in late September. Moreover, Germany and France do not want to increase the rescue fund's size out of concern for their own finances.

To ease the E.C.B.'s policy shift, Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France promised that the financial stability facility would take on responsibility for bond-buying in the secondary market as soon as its new powers were in effect.

But markets may not be convinced that either institution has the political stamina and the financial firepower to shield Italy durably from danger unless Rome achieves an improbable twin conversion to fiscal discipline and economic growth.

Critics say past E.C.B. bond-buying has had only temporary calming effects and did not prevent Greece, Ireland or Portugal from requiring bailouts.

"Over time, we believe that ongoing selling pressure will force the E.C.B./E.F.S.F. to eventually hold close to half of the traded Italian and Spanish debt or around €850 billion," economists at Royal Bank of Scotland said in a research note.

Such a huge holding of southern countries' debt could amount to a de facto mutualization of euro zone debt risk, potentially heightening a political backlash in Northern Europe.

Even if the fire subsides for now, prepare for more blazes.

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