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14/9/2011

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The weight of the euro on Merkel's shoulders

BERLIN

Chancellor balances need for bold action against Germans' aversion to aid

BY NICHOLAS KULISH

As Europe struggles to reverse a plunge in financial confidence, the world waits for the German chancellor, Angela Merkel, to make a fundamental choice. She, more than any European politician, must either summon the leadership to

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rescue the euro or concede that the political will is not there.

Mrs. Merkel faces far-reaching decisions about how to deal definitively with the debt crisis in Europe and, more immediately, whether to allow Greece to default or even to leave the currency union. U.S. officials fear that if she does not act more decisively, bank lending could freeze up and the result would be another sharp financial downturn on both sides of the Atlantic.

Fears of a worsening debt crisis have hit European stocks hard, especially shares of French banks, impelling the French government to declare its support for the country's three largest financial institutions. The turmoil has added to worries that the Greek crisis could prove difficult to contain without more robust action from Germany and, ultimately, its taxpayers.

The project of European integration, which began after World War II, is also on the line. Compelling Greece to abandon the euro, as more and more voices on the German right are demanding, would be a jarring setback for solidarity on the Continent.

Critics say Mrs. Merkel has focused too much on protecting her political standing inside Germany, placing her position as chancellor above the need for bold, risk-taking leadership to rescue the European currency zone. But that could mean sinking more German money into

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E.U. steps up pressure on Athens to act on debt

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PARIS

Prospect of default raised as urgent talks set with Greek prime minister

BY STEVEN ERLANGER AND MATTHEW SALTMARSH

In the face of heightened market pressure to resolve the Greek debt crisis, the president of France and the chancellor of Germany will hold a video conference Wednesday evening with the Greek prime minister, George A. Papandreou, officials announced Tuesday, with the prospect of a further restructuring of Greek debt hovering in the air.

President Nicolas Sarkozy and Chancellor Angela Merkel initially planned a joint statement in support of their banks earlier Tuesday, but Berlin argued against it as unnecessary, French officials said. Still, France is pressing for a stronger signal from Germany that Europe will act to resolve the issue before new doubts about Greek solvency spread further contagion to other indebted states and their banks.

Mr. Sarkozy met Tuesday evening to discuss the euro crisis at the Élysée Palace in Paris with Herman Van Rompuy, the president of the European Council, which represents the 27 heads of government and state in the European Union. But neither man spoke afterward to the press.

Mr. Van Rompuy has been asked by Germany and France to head a similar council of the 17 countries in the euro zone, and he has been an important mediator between Paris and Berlin. Plans were clearly being laid for a serious conversation with Mr. Papandreou, whose government has proved incapable so far of making the kinds of legal changes and budget cuts in the middle of a deep recession that Athens had promised its European partners and the International Monetary Fund.

Despite the stepped-up pace of economic diplomacy, Europe's response to the debt crisis still appeared to be behind the curve. That was underscored by the announcement that Timothy F. Geithner, the U.S. Treasury secretary, would make a rare, if not unprecedented, appearance at a meeting of European finance ministers, to be held Friday in Wroclaw, Poland. The trip will be his second across the Atlantic in a week, after the Group of 7 session in Marseille this past weekend.

''Clearly the U.S. Treasury is disappointed with the direction of the European debt crisis and is looking for action, before further sections of the banking system are drawn in and a global financial crisis is re-visited,'' Chris Turner and Tom Levinson, strategists at ING, wrote in a research note.

Growing concern in the United States that Europe's problems threaten the broader global economy were also evident from news that President Barack Obama, during a meeting with Spanish-

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ennis court

MIKE STOBE/GETTY IMAGES FOR ATP-AFP

Novak Djokovic with his U.S. Open trophy on Tuesday. He said that the final match was the best that he had played this year.

A REALITY CHECK FOR EUROPE'S BANKS
Christine Lagarde has broken the code of silence regarding European banks, Andrew Ross Sorkin writes. *PAGE 20*

Euro's fate is resting on Merkel's shoulders

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an ever-deepening economic union that voters have shown an antipathy for.

The governing coalition of Mrs. Merkel is already splintering over the Greece bailout. Her party, the Christian Democratic Union, has suffered setbacks in state elections, including one this month in the state of Mecklenburg-West Pomerania, where her parliamentary home district is located. Her father died shortly before that election, adding personal anguish to a politically fraught moment.

Mrs. Merkel's efforts to please both sides on the question of the debt crisis — through stern talk about Greece's failure and profligacy on the one hand and a series of conditional debt guarantees to prop up Europe's problem child on the other — have succeeded in ultimately pleasing neither.

Supporters argue that Mrs. Merkel has worked in a typically low-profile, methodical fashion to make the best of a difficult situation, winning passage for unpopular bailouts while wringing greater fiscal responsibility from the most heavily indebted countries.

Mrs. Merkel warned Tuesday that Greece must not default because it could lead to a domino effect among other euro zone countries.

"In a currency union with 17 members, we can only have a stable euro if we prevent disorderly processes," Mrs. Merkel said during an interview with RBB Radio Berlin-Brandenburg. "Therefore it is our top priority to avoid an uncontrolled default, because it would hit not only Greece. The danger would be very high that it would hit many other countries."

She said she was convinced that the euro zone countries could find a common solution to the crisis engulfing the euro. "I am optimistic that it will happen," she said, adding, "It cannot be done in a few measures but through a special, long process."

The resignation on Friday of Jürgen Stark, a German member of the executive board of the European Central Bank and the second significant German figure at the bank to leave its governing council this year, offered a window into the intensity of German opposition to the steps that Germany and the central bank have already taken in bailing out the weaker southern countries.

"The chasm between what is needed in terms of economic policy and what is possible in terms of domestic politics and party politics has widened," said Cornelius Adebahr, a Europe expert at the German Council on Foreign Relations in Berlin. "She needs to show stronger leadership, but so far she hasn't even revealed in what direction she really wants to move."

Events appear to be forcing Mrs. Merkel to tip her hand.

With the latest market assault this week on French banks, the spillover from the debt crisis has now reached the German border. With first Italy and now France affected, problems once dismissed as confined to the periphery of Greece and Portugal have arrived at the core of Europe, and with them unavoidable questions about the future of the Continent.

An Italian bond sale got a tepid response from buyers Tuesday despite the disclosure of official talks between Rome and China's sovereign wealth fund, helping to push borrowing costs up across Europe.

The Italian Treasury sold €3.9 billion, or $5.4 billion, of a new five-year bond at an average yield of 5.6 percent. That compared to a rate of 4.93 percent the last time securities of a similar maturity were sold, on July 14.

The yield on 10-year Italian bonds was 5.622 percent in late European trading, again approaching the 6 percent level that is considered to be unsustainable — and that prompted the E.C.B. to intervene and start buying Italian and Spanish debt on Aug. 8. By comparison, Greece's 10-year bond yields rose 1.04 percentage point, to 21.414 percent, after earlier climbing to a euro-era record of almost 25 percent as concerns about a near-term Greek default increased.

President Nicolas Sarkozy of France, Mrs. Merkel's buoyant, antic foil, hopes to draw the German leader into deeper commitments to an economic government for the currency zone, reaffirming France and Germany as the motor of European integration. And if France's struggles are not enough to prod Germany and its phlegmatic leader to take bold action, analysts say, it is likely that nothing will.

"We've been pretending for a year and a half that the Greek crisis could be solved this way, but it's not the case, and this has created uncertainty," said Guntram B. Wolff, deputy director of Bruegel, a research organization based in Brussels.

The latest volatility and vulnerability in European markets may well mean the end of Mrs. Merkel's efforts to straddle the fence between shielding Greece from default and avoiding an irrevocable step toward deeper economic and fiscal union among the euro zone countries.

"She needs to show stronger leadership, but so far she hasn't even revealed in what direction she really wants to move."

The prolonged state of confusion and uncertainty may be as bad or even worse than the underlying problems themselves.

"If they would agree on a specific solution, say to the default of Greece, I would see a relatively low likelihood that the euro zone would also default or be destroyed," said Michael Schröder, head of the research department of international finance at the Center for European Economic Research in Mannheim, Germany. "What's really a danger is this chaos which we have at the moment."

To observers outside Germany, the stern chancellor appears strong, but unwilling to act decisively. Inside Germany she sits atop a fractious and increasingly unreliable coalition of three parties — her Christian Democratic Union, the Christian Social Union of Bavaria and the pro-business Free Democrats.

France, as a presidential republic with a majority party in Parliament, has fewer domestic political problems than Germany, with its federal system and negotiated coalitions. But Mr. Sarkozy knows that he cannot move without Germany. Much as the two leaders do not like each other and have very different personalities, Mr. Sarkozy has sought to ensure that France and Germany move as one and that he is outwardly supportive of Berlin.

Much hinges on getting all 17 countries in the euro zone to ratify the decisions of July 21, as the French Parliament has done, which includes an increase in the bailout fund and an expansion of its powers. Those decisions would already be a shift from Germany's harder-line positions on the euro.

Steven Erlanger contributed reporting from Paris, Matthew Saltmarsh from London and Judy Dempsey from Berlin.

Pressure mounts for Greece to act

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speaking journalists in Washington, called on euro zone leaders to show markets that they were taking responsibility for the debt crisis.

"In the end the big countries in Europe, the leaders in Europe must meet and take a decision on how to coordinate monetary integration with more effective coordinated fiscal policy," EFE, a Spanish news agency, quoted Mr. Obama as saying.

France and Germany are pressing to put into place the decisions made at the last euro zone summit meeting in Brussels on July 21, but those changes have to be ratified by all 17 members. Mrs. Merkel is pressing for a vote in the Bundestag, the German Parliament, this month, and said Tuesday that Germany would ensure there would be no "uncontrolled default" of Greece that could pull down the euro zone.

"In a currency union with 17 members, we can only have a stable euro if we prevent disorderly processes," she said. "Therefore it is our top priority to avoid an uncontrolled default, because it would hit not only Greece. The danger would be very high that it would hit many other countries."

Mrs. Merkel emphasized again that there was no quick fix to the euro, and that a comprehensive rescue package needed time. "It cannot be done in a few measures but through a special, long process," she said. And she vowed again that "everything must be done to keep the euro area together politically, because we would very quickly face a domino effect."

But her talk of default, uncontrollable or not, was seen as important, because there is increasing skepticism that even the second bailout of Greece, part of the July package, will be enough to bring it to a sustainable level of debt. Many experts now predict that an expanded €440 billion, or $604.3 billion, rescue fund, once ratified, could be used to sharply restructure Greek debt by the end of the year and to recapitalize banks that are made vulnerable by further write-downs on Greek debt.

Despite the exposure of large French banks to Greek and other sovereign debt, French officials insisted again Tuesday that the banks were solid, well capitalized and could handle any outcome to the Greek mess.

The trick for European leaders is to isolate Greece as much as possible, even if that means the kind of restructuring they denied they would ever contemplate six months ago.

European stocks swung into positive territory, having earlier declined on fears about French banks' exposure to shaky European debt and their ability to finance themselves in dollars. The Euro Stoxx 50, a benchmark of euro zone blue-chip issues, closed up 2.1 percent and the DAX in Frankfurt climbed 1.9 percent. Major U.S. indexes were higher at midafternoon on Wall Street, while Japanese shares rose.

While the immediate problems revolve around Greece, much-bigger countries like Italy, which is also overstretched, have been losing market confidence as well, creating even greater worries.

On Tuesday, the Italian Treasury sold €3.9 billion of a new five-year bond at an average yield of 5.6 percent. That compared with a rate of 4.93 percent the last time securities of a similar maturity were sold on July 14. Demand at the auction was 1.28 times the amount being offered, compared with 1.93 times at the previous sale.

Analysts said that demand was disappointing and that the European Central Bank had been seen by traders to be buying Italian bonds around the auction as part of their program of asset purchases to stable volatile markets.

"It is our top priority to avoid an uncontrolled default, because it would hit not only Greece."

The yield on 10-year Italian bonds rose 0.12 percentage point Tuesday, to 5.665 percent, uncomfortably close to the 6 percent level that is considered to be unsustainable, and that prompted the E.C.B. to intervene and start buying Italian and Spanish debt on Aug. 8. Spanish bonds were trading at 5.342 percent, a slight rise from Monday.

Greece's 10-year bond yields earlier climbed to a euro-era record near 25 percent as concerns about a near-term Greek default increased and were up 1.04 point, at 21.416 percent, at the end of European trading. The euro rose to $1.3714 by midafternoon in New York from $1.3679 late Monday.

Prime Minister Silvio Berlusconi of Italy flew to Brussels and Strasbourg on Tuesday to reassure European leaders of Italy's "strong commitment" to balancing its budget by 2013. Speaking after meeting with Mr. Van Rompuy, Mr. Berlusconi said that the lower house of the Italian Parliament would give final approval to the government's €54 billion austerity package in a confidence vote Wednesday. Mr. Berlusconi added that the savings from the measures would exceed those originally agreed to with the European Central Bank.

He said Italy's economic foundations were "very good," that manufacturing was strong, that Italian families had considerable savings, and that Italy was second only to Germany in "terms of the well-being and the wealth of the country."

Some analysts said the new package may not be enough.

Robert O'Daly, an economist at the Economist Intelligence Unit, said that to restore confidence, the Italian government would also have to "come up with a coherent medium-term strategy to improve the country's dismal economic growth performance." But he added that "does not seem likely to happen" given the differences within the ruling coalition.

Separately, reports of a meeting last week in Rome between Finance Minister Giulio Tremonti of Italy and the chairman of China Investment Corp., Lou Jiwei, were confirmed by Mr. Tremonti's office on Tuesday, news agencies reported.

Italy trumpeted the meeting as a sign that China was prepared to buy more government bonds. The C.I.C. had $374 billion as of Dec. 31, 2010, according to its annual report. Most of that money is already invested, however, and the C.I.C. has not received any large infusions of money from the country's foreign exchange reserves recently. The C.I.C. also specializes in purchases of stocks, not bonds, although it may park money in bonds at times.

Analysts were skeptical in any case. China's purchase of bonds during the crisis from other euro zone countries like Spain and Portugal had limited effects.

"Purchases of Italian bonds or other Italian assets by China's sovereign wealth fund would buy Italy some time, but that is all," Mr. O'Daly said. "As seen with the E.C.B.'s purchases of €40 billion to €45 billion worth of Italian government bonds in August, the effect was temporary."

Matthew Saltmarsh reported from London. Elisabetta Povoledo in Rome, Judy Dempsey in Berlin and Keith Bradsher in Hong Kong contributed reporting.

ONLINE: EUROPEAN DEBT CRISIS TRACKER
An interactive graphic follows the evolution of the sovereign debt crisis in the euro zone: **global.nytimes.com/business**