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A strategy, but no sure solution

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INSIDE EUROPE

BRUSSELS A cloud of gloom hangs over Brussels before yet another summit meeting to thrash out yet another "comprehensive strategy" to tackle a sovereign debt crisis that Europe has failed for two years to stem and that now threatens the world economy.

Gallows humor was rife among the grandees of European integration at the annual conference of the Friends of Europe, a research organization, on "the state of the union" last week.

"Hopefully, next year we won't be talking about Greek debt," Étienne Davignon, 79, a former European Commission member and patriarch of the European project, said jokingly in his closing remarks. "Either it will have gone or we will have gone."

The opening session was billed as, "The E.U.'s three ages: rise, decline and fall?" The question mark was the only concession to hope.

Weary cynicism surrounds the meeting of the 27 E.U. leaders set for Sunday, their sixth attempt this year to draw a line under the euro zone crisis, which has led to bailouts of Greece, Ireland and Portugal and is now singeing Italy and Spain.

They trumpeted a "comprehensive response" back in March, but, mainly because of German caution, adopted a catalogue of half-measures that the British prime minister, David Cameron, described last week as "a bit too little, a bit too late."

In July, with bond market contagion spreading for the first time to Italy — the euro zone's third-biggest economy, after Germany and France — leaders of the bloc agreed on a second bailout for Greece involving "voluntary" write-downs for private bondholders and more powers for their bailout fund, the European Financial Stability Facility.

Traders quickly realized the accord would take months to implement and might be derailed in any of the 17 national parliaments whose approval was needed or by Greece's failure to achieve its fiscal goals. Confidence evaporated.

Spanish and Italian borrowing costs were driven so high that the European Central Bank had to intervene with emergency measures in August to buy those countries' bonds in an attempt to push yields down.

After weeks of bruising debate in the German and Slovak Parliaments and haggling with Finland over its demand for collateral on Greek loans, the beefed-up €440 billion, or $611 billion, bailout fund is finally ready to act.

But the goalposts have moved in the meantime. The situation has deteriorated and more radical action is now required. Greece has strayed off course again and doubts about whether it will ever repay its debts have hardened as the country has slumped deeper into recession and public resistance to austerity measures has mounted.

Greek debt relief may be too small to ward off a hard default, and banks may struggle to raise cash.

Germany and its North European allies are demanding that private bondholders be made to contribute more toward a second rescue for Greece, but still on a "voluntary" basis with no losses for taxpayers or the E.C.B.

The talk now is of building a firewall around Greece and convincing investors that the bonds of other euro zone members are safe, without another round of ratifications in member states.

The main elements in the latest "comprehensive strategy" are: reducing Greece's debt and giving the country longer to recover; bolstering European banks' ability to absorb losses; leveraging the rescue fund to prevent contagion to larger economies; and taking steps toward closer euro zone fiscal integration.

Yet there is scope for each of these elements to fall short or be overtaken by events, especially with the economic outlook darkening as austerity measures cripple demand.

Greek debt relief may be too small to ward off a hard default. Banks may struggle to raise capital and governments fearful for their own credit ratings may equivocate about what to do if the lenders cannot raise capital on the markets.

Policy makers hope to stabilize the euro zone's bond market by using the bailout fund to offer partial loss insurance to investors buying new Spanish or Italian bonds. This may not be enough to restore confidence, if Italy's chaotic politics, compounded by the country's economic slowdown, thwart austerity plans. Markets are bound to test Europe's defenses.

Further credit ratings downgrades could exacerbate the crisis. If France's AAA rating is pulled into doubt because of the capital needs of its banks, which are heavily exposed to peripheral euro zone debt, the entire rescue strategy could falter.

With so many "ifs," it is anything but certain that this "comprehensive strategy" will be the one that does the trick.

Pressure from other major countries for decisive action, which dominated the meeting of Group of 20 finance ministers in Paris last weekend, may improve the Europeans' chance of success.

The world's treasuries and central banks are so alarmed at the risk of a financial meltdown that they may be ready to pile in to support even a shaky European plan.

European policy makers still reject the nuclear option of a mandatory restructuring of Greek debt, which would lead to a "credit event" and the payment of default insurance, sending a shock wave through the financial sector.

Instead, private bondholders face a bigger "voluntary" write-down of as much as 50 percent while euro zone governments and the E.C.B. are shielded from losses on Greek debt to avoid a public backlash that would make further rescue measures impossible.

It is easier for European politicians to support banks that are unable to raise private capital than it would be to acknowledge that in the Greek bailout, they had poured taxpayers' money down a hole.

Radical solutions like using the E.C.B. as Europe's lender of last resort or issuing bonds backed jointly by the euro zone's members are politically taboo in Germany.

Barring such game-changers, expect the euro zone debt crisis to rumble on and on, if it does not explode.

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