FINANCIAL TIMES

Last updated: October 20, 2011 10:57 pm

Europe on edge as rescue talks stall

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By Peter Spiegel in Brussels and Gerrit Wiesmann in Berlin

European leaders will be forced to hold a second summit, perhaps as early as Wednesday, because of the inability of Germany and France to reach a deal on how to increase the firepower of the eurozone's €440bn rescue fund.

European leaders confirmed that a high-stakes summit on Sunday aimed at finalising a plan to shore up the eurozone would proceed. But one senior German official said that no substantive decisions would be taken on giving additional resources to the fund, called the European Financial Stability Facility, so it could tackle the growing threat to large eurozone banks and the Italian bond market.

"There will be no agreements," said the senior German official. "This will now happen Wednesday at the earliest." French officials said the second summit could be held before Wednesday.

Asked why EU leaders were still holding the Sunday meeting, the German official said: "That's a good question. Sarkozy wants one."

Another top European official insisted that important decisions would still be made at the summit, and diplomats said there was growing consensus that Greek debt holders would be pushed to accept a 50 per cent loss on their bonds. In addition, there was general acceptance with a European Banking Authority analysis that banks would need to raise about €80bn in new capital, diplomats said.

Still, in a statement put out by French president Nicolas Sarkozy's office, Paris said Sunday's meeting was now intended to "discuss in depth" the much-touted plan rather than come to any decisions, which would be made at the second gathering.

"We've lost the main parachute and we're on the reserve chute and we're not sure that will even work," said a senior EU official.

Highlighting the global gravity of the situation, it was revealed that Mr Sarkozy, Angela Merkel of Germany, the UK's David Cameron and US President Barack Obama on Thursday conducted a video conference to discuss the economy.

Differences over the EFSF have widened in recent days after some officials warned the leading plan for overhauling the fund – which would involve it guaranteeing about 20 per cent of losses on Spanish and Italian bonds – might not be effective.

According to one EU official, the plan began unraveling due to fears it would cost France its totemic triple-A debt rating because it puts all eurozone governments on the line for potentially huge losses. The EFSF's ability to raise rescue money at low interest rates is directly tied to France's and Germany's triple-A status, meaning a French downgrade could lead to a collapse of the EU's entire financial rescue system.

Indeed, bonds issued by the EFSF for Irish and Portuguese bail-outs have seen heavy selling this week amid fears the fund could be undermined. Borrowing rates for Italian bonds also spiked on Thursday, closing above 6 per cent for the first time since the European Central Bank began heavily buying them in early August.

In recent days, France has made a renewed effort to change the EFSF plan, reverting to an earlier proposal that would give the fund access to the ECB's unlimited resources as a way of increasing its firepower.

The ECB and Germany have resisted the move, however, and the standoff led to tensions at a hastily-arranged meeting in Frankfurt of EU leaders Wednesday evening, which included both Mr Sarkozy and Mrs Merkel.

"Yesterday went very badly," said a European official briefed on the session.

Because of the standoff, Ms Merkel was unable to present the Bundestag with full details of the EFSF plan. Under new German legislation, Ms Merkel must get a green light from the parliament before agreeing any major changes to the rescue fund.

"Merkel doesn't have enough time to run it by the Bundestag," said another senior European official.

Additional reporting by Quentin Peel in Berlin and David Oakley in London