France and Germany at odds over new deal to contain crisis

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PARIS

BY STEVEN ERLANGER

Global markets rose and the euro gained Friday, despite clear signals from French and German officials that they had sharp differences about how to handle the euro crisis heading into an important weekend summit meeting in Brussels.

As ever, the focus is on Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France, who have made a habit of cobbling together deals to lay out before their European Union colleagues. But agreement now is harder than before, as Paris and Berlin are facing core disagreements — with consequences for domestic politics and their own budgets — about how to maximize the euro zone's financial rescue fund and how far the European Central Bank should intervene in the bond markets, either on its own or through the bailout fund.

Already the two leaders have announced that the meeting Sunday, which has been delayed once to allow more time to negotiate, would be followed by another as early as Wednesday. That announcement, paradoxically, seemed to buoy the markets, apparently because the Europeans were focusing intensely again on how to resolve the crisis.

Stocks in Europe rose 2 percent to 3 percent Friday and in the United States

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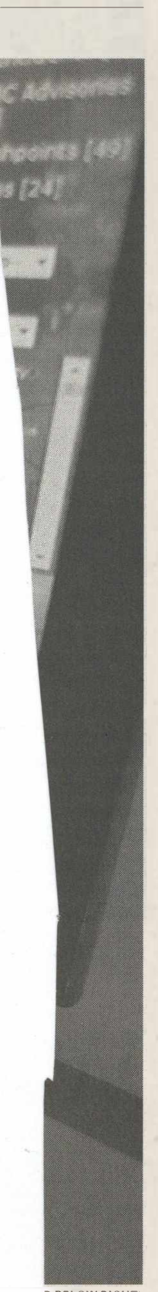
EUROPE MOVES ON GREEK DEBT

Finance ministers agreed Friday to release part of an €8 billion fund to help prevent Greece from defaulting. ***PAGE 9***



Ministers reach deal to release loan to Greece

BRUSSELS

Finance chiefs provide E.U.'s share of €8 billion to ward off default

BY STEPHEN CASTLE, JACK EWING AND LIZ ALDERMAN

European finance ministers agreed Friday to release their part of an €8 billion international loan package to prevent Greece from defaulting within weeks, as a divided euro zone began six crucial days of talks designed to calm the debt crisis.

With France and Germany on collision course over moves to increase the firepower of the euro zone's bailout fund, the deal to help Greece provided some rare good news for ministers battling to produce a package of measures to reassure anxious markets.

The euro zone has now set itself a Wednesday deadline to deliver a long-promised comprehensive solution for the crisis. But it is struggling to produce measures that will impress financial markets that have consistently punished the bloc when it has sought to muddle through.

The loan to Greece will go ahead in the first half of November subject to approval from the board of the International Monetary Fund, which finances about one-third of the payment, a statement from the ministers said.

As discussions started there was no single plan to increase the firepower of their bailout fund and European officials were at loggerheads with banks over how to cut Greece's debt mountain.

Plans being debated would lever up the spending power of the euro zone's €440 billion rescue fund, strengthen sickly European banks and persuade private investors to write off half of Greece's debt. The burden of Greek debt is now acknowledged by several key players to be unsustainable.

But almost two weeks after Paris and Berlin pronounced themselves in agreement, the two countries were embroiled in a game of brinksmanship over how to expand the bailout fund, a dispute that one analyst warned could endanger more than five decades of European integration.

Jean-Claude Juncker, who also chairs the meetings of euro zone finance ministers, said that Thursday's move to delay final decisions until the second summit meeting Wednesday looked "disastrous" to the outside world. He canceled a press conference scheduled for after Friday's meeting of the 17 euro zone finance ministers, suggesting that no breakthrough was imminent.

Officials were taken aback by the depth of the French-German discord that emerged Wednesday during discussions in Frankfurt attended by Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France.

At issue is how to leverage the bailout fund for the euro zone, the European Financial Stability Facility, to enable it to head off the threat of mounting borrowing costs to countries including Italy and Spain. Though Mrs. Merkel had categorically rejected proposals under which this would be done with the aid of the European Central Bank, Mr. Sarkozy unexpectedly pressed that proposal Wednesday.

Such a model would allow for maximum efficiency and firepower without risking France's triple-A credit rating as a presidential election looms in next year.

Protecting it has been a major objective of Mr. Sarkozy ever since Standard & Poor's downgrade of the United States' triple-A rating this summer caused investors to scrutinize other top-

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FINANCE ECONOMY BUSINESS

OLIVIER HOSLET/EUROPEAN PRESSPHOTO AGENCY

Evangelos Venizelos of Greece, left, Christine Lagarde of the I.M.F., François Baroin of France and Didier Reynders of Belgium at the finance ministers' meeting in Brussels on Friday.

Euro zone ministers agree to Greek loan

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rated countries with high debts and deficits, and particularly France.

While ratings agencies initially said France was not at risk, they started changing their tune this week as political discord over a solution to the crisis mounted. S.&P. on Friday said it would probably lower the nation's triple-A rating, and the ratings of Spain, Italy, Ireland and Portugal, if Europe fell into a recession. Moody's also cast doubt on France's rating this past week.

Arriving at Friday's meeting, Maria Fekter, the Austrian finance minister, said seven models were being discussed to leverage the E.F.S.F. and confirmed that employing the E.C.B. had been ruled out by Austria and Germany.

With Mrs. Merkel unlikely to yield, ministers were expected to study a plan under which the E.F.S.F would have several options to insure against losses on Spanish and Italian bonds. The precise model might not be selected but left to the bailout facility.

Germany is still pressing to create a special fund, administered by the International Monetary Fund, alongside the E.F.S.F., though, for technical reasons, that would take time to set up, said one official.

Willem Buiter, the chief economist at Citigroup, said that the insurance option would be insufficient to insulate Italy and Spain throughout next year. "It isn't the big bazooka that some would have us believe. It helps us to get to the middle of next year before we start panicking again," he said.

"This could end up, if it goes wrong not just with the end of the euro but the end of the European Union," he said, adding that there was "still an element of denial in Europe and still no recognition that there will have to be a restructuring beyond Greece."

Though pressure is mounting for a 50 percent write-down of Greek debt, banks were still far from agreeing to move from the 21 percent haircut that they agreed in July, according to bank and European officials with knowledge of the discussions.

Yet key players, including the International Monetary Fund, agree that the most important problem to confront is building a firewall big enough via the bailout fund to protect Italy and Spain from the risk of contagion.

Markets have pushed Italian and Spanish yields towards record levels. On Thursday, Italy's 10-year benchmark yields broke above the 6 percent level for the first time since August.

"The key issue is how you make the E.F.S.F. more efficient, more effective in terms of firepower," said Nick Matthews, senior European economist at Royal Bank of Scotland. There is no political will to go back and increase the absolute size."

Mr. Matthews said that the idea of using the E.F.S.F. to issue bond insurance has numerous problems. For example, while an insurance company could secure a large pool of customers with the expectation that only a few will be paid, the E.F.S.F. would be insuring bonds from a small group of customers — European countries. That means the risk would be concentrated.

> **"This could end up, if it goes wrong, not just with the end of the euro but the end of the European Union."**

"We have doubts whether the insurance scheme will work, I mean durably work," Mr. Matthews said. "Let's hope there is something else on the table."

"If you want to see a durable and sustainable solution you need a bigger E.F.S.F.," he added.

With euro zone countries unwilling to commit more money to the E.F.S.F., only backing from the E.C.B. would increase the fund's clout, he said.

But even though this option is favored by senior officials within the I.M.F., the E.C.B. does not want to serve as a backstop, even if Mrs. Merkel agreed to it doing so.

"If you want to have something where there is no doubt about the firepower of this vehicle then you will always fall back on the E.C.B.," Mr. Matthews said.

Mr. Buiter said that a likely bank recapitalization program expected to pump less than €100 billion into the European sector should be elevated more than three times to take account of "legacy losses" and the likely impact of low growth in the European economy.

The I.M.F. wants to raise the scale of the bank strengthening exercise though with few prospects of success.

Mr. Matthews said a bank recapitalization plan would be effective only if there were also measures in place to prevent the value of European sovereign debt from declining further.

"It's something that needs to be done, but if you inject capital into the banking sector without any policy tools to stabilize sovereign debt, it could be a futile exercise," he said. "You can recapitalize banks and put them in a better position to withstand a Greek haircut. But unless you are able to break this link between the sovereigns and banks then it's not going to be enough."

France and Germany bicker over crisis plan

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by more than 1 percent.

But the announcement might also be because Mr. Sarkozy needs the pressure of other countries to bring Mrs. Merkel around to a more flexible position of how to use the bailout fund, the European Financial Stability Facility, and the central bank.

Mr. Sarkozy has now rushed twice to Germany for talks with Mrs. Merkel, the last time on Wednesday, as his wife was giving birth, to press for a deal. The meeting was testy, German officials said, who complained that France was "not budging an inch." Mr. Sarkozy, clearly the supplicant in the relationship, keeps speaking of a "European rendezvous with history," while Mrs. Merkel keeps repeating that "there is no magic bullet" and that a long-term solution will take time.

The "French-German couple" has been vital to each of the agreements reached by the European Union during this two-year crisis. But none of the deals has been sufficient to solve even the problem of Greek indebtedness — which is growing ever worse in an austerity-driven recession — let alone the problem of contagion spreading now to Italy and Spain. Nor has there been a deal on how to recapitalize European banks weakened by exposure to sovereign debt. Those are the main issues on the agenda.

On Greece, Germany appears willing to do a deal to restructure its debt to no more than half of its face value, to try to bring the debt burden to a sustainable level. But Berlin wants the private sector — investors and the banks — to agree voluntarily to do that, to avoid a formal default and a "credit event" that would create complications. The banks are reluctant. They already agreed to what was billed as a 21 percent "haircut" on their Greek debt in July, a deal not yet implemented, and they are reluctant to reopen the file. Nor are they confident that enough private bondholders will agree to such a large cut.

France and the European Central Bank do not want to restructure Greek debt further, fearing market contagion and, for Paris, additional pressure on French banks that hold significant amounts of Greek, Spanish and Italian debt. A major recapitalization of French banks would put more strain on France's budget and require new cuts elsewhere to meet deficit targets, and could thus jeopardize France's coveted triple-A credit rating. That would be bad politics in an election year and Mr. Sarkozy is already unpopular.

There is also a fear that banks would cut back on lending rather than try to raise more capital while their stock prices are down, which could lead to a new credit crunch in a period of flat growth. France wants Europe to collaborate to recapitalize banks, ideally by turning the E.F.S.F. into a bank, which could draw on loans from the European Central Bank.

But Germany has rejected that option, and the European Central Bank also has refused to be used as an open source of financing for sovereign debt. "The path is closed for using the E.C.B. to ease liquidity problems," Mrs. Merkel told her parliamentary caucus in Berlin, Reuters reported.

Mrs. Merkel wants each country to be responsible for recapitalizing its own banks, and turn to the E.F.S.F. only in an emergency. Politically, it is easier for her to explain to Germans that German money is being used to recapitalize German banks than to concede that it is being used for everybody's banks. Mrs. Merkel is also compelled politically and juridically, by the constitutional court, to get a mandate from Parliament's budget committee before committing new funds, a restriction Mr. Sarkozy does not face.

But there is progress on bank recapitalization, in part because the Europeans have decided that the amount required is half what the International Monetary Fund and some other experts suggest, in part because the Europeans are less willing than others to write down the value of Italian and Spanish debt. Even so, France is asking for a period of nine months for banks to meet recapitalization targets.

France and Germany also disagree on how to leverage or maximize the €440 billion, about $609 billion, held by the E.F.S.F. to create a "wall of money" to discourage the markets from speculating further on Spain and Italy. The fund has already committed about €143 billion to Greece, Portugal and Ireland, and the German government has promised taxpayers that its own contribution, as the largest contributor, will not be more than €211 billion.

There are a variety of ideas on how to leverage the fund, but so far they have run into problems with treaties and the European Central Bank has opposed the idea that it would guarantee loans made by the fund. Germany has discussed using part of the E.F.S.F.'s remaining funds as "insurance" to guarantee a portion of any potential losses on future bond auctions for Italy and Spain, but Paris would still prefer that the E.F.S.F. borrow directly from the central bank. France might agree to the German idea if the insurance ratio is higher.

And there are reports that the I.M.F. might also provide some cheaper credit to European countries facing severe market pressure on their bonds.

There is also discussion of implementing a successor fund to the temporary E.F.S.F., envisioned for mid-2013, to run simultaneously with it, again increasing its firepower. But that permanent successor fund, the European Stability Mechanism, would require a whole new round of approvals from member states and their parliaments.