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116

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# If Spain is rescued, who foots the bill?

**LONDON**

## Any bailout would strain Europe's resources and leave little aid for others

BY LANDON THOMAS JR.

The urgent question of who will provide the money that Madrid needs to stay in business has become the latest challenge for European policy makers, as Spain fast eclipses Greece as the focus of the euro zone debt crisis.

A European bailout of Spain, the euro zone's fourth-largest economy, after Germany, France and Italy, is becoming a more distinct possibility. With each passing day, turmoil mounts over the government takeover of the giant Spanish mortgage lender Bankia, the flight of money to safer borders and a worsening recession.

A rescue, if it came, would strain the resources of Europe's new €700 billion, or $867 billion, bailout fund that is to become available this summer. And it would leave little margin for any additional bailouts.

On Wednesday, the European Commission urged Spain to take market-calming measures, and Lael Brainard, an under secretary at the U.S. Treasury Department, arrived in Madrid for talks with government officials, as part of a regional tour. Meanwhile, worries about Spain helped send stock markets down broadly in Europe, with Wall Street also retreating in afternoon trading.

In the bond market, the Spanish government's borrowing costs are fast approaching the symbolically dangerous level of 7 percent on 10-year bonds. The rise has stoked worries that Spain might need bailouts similar in scope — though many times larger — than those extended to Greece, Portugal and Ireland. Interest rates in that range had pushed them out of the debt markets that governments rely on to finance their operations.

"At 7 percent, it will be very hard for Spain to obtain funding," said Santiago Carbó Valverde, an economics professor at the University of Granada and a research consultant for the Federal Reserve Bank in Chicago. "It's not just the government either, but big banks and companies as well. The markets will close."

On Wednesday, Spain's economy minister, Luis de Guindos, acknowledged as much when he said current interest rates were "not sustainable in the long term."

The yield, or interest rate, on Spain's 10-year bond rose 0.21 percentage point Wednesday, to 6.61 percent. In Italy — a country whose debt burden of 120 percent of gross domestic product is much higher than Spain's — the yield on 10-year bonds rose about 6 percent, hitting a 10-month high.

Since the nationalization of Bankia on May 9 signaled the perilous state of Spain's banking industry, and drew new attention to the limited ability of the government to shore up the banks and prevent the flight of capital from the country, the prime minister, Mariano Rajoy, has insisted that Spain will not need a Greek-style bailout.

No head of state would welcome such intervention, because as Athens and Dublin and Lisbon have found, those rescues typically come with demands for deeper budget cuts and new fiscal rigor.

But Mr. Rajoy's administration has been floating the idea of engineering a bailout by other means — getting Europe's rescue fund to provide money directly to the country's banks or to buy Spanish government bonds on the open market, without Europe's demanding new levels of scrutiny and tough pay-

*SPAIN, PAGE 14*

AVIER LIZON/EPA

**Luis de Guindos said Wednesday that Madrid's borrowing costs weren't sustainable.**

**E.U. SAYS HUNGARY IS FIT TO RECEIVE AID**
Budapest has "taken the necessary action" to correct its "excessive deficit" this year, the commission said. *PAGE 14*

# E.U. urges tighter coordination of euro zone banks and budgets

**BRUSSELS**

BY JAMES KANTER
AND PAUL GEITNER

The European Commission on Wednesday urged euro zone countries toward greater fiscal integration, even as it prodded national governments to live up to the budget rules they had already agreed on.

José Manuel Barroso, the president of the commission, said it was important for the euro zone to commit to tighter cooperation now, in order to restore investor confidence, even if the results of such a strategy — including the creation of a banking union and the issue of bonds backed jointly by euro zone members — were still a long way off.

"For full confidence in the future of the euro area, it is important that member states agree to launch a process toward more integration — financial and economic integration," Mr. Barroso said.

Mr. Barroso made his call as the commission, the European Union's executive arm, released report cards on the economies of the 27 E.U. members that underlined the difficult role that the commission plays in a bloc where much power still rests with national capitals.

The commission cautioned François Hollande, the new French president, against overspending in trying to spur

*EURO ZONE, PAGE 14*

# E.U. deems Hungary fit to receive aid once again

BRUSSELS

## For deficit-cutting efforts, commission recommends release of withheld funds

BY PAUL GEITNER

Pulling back from an unprecedented threat, the European Commission said Wednesday that Hungary had made enough progress in bringing down its budget deficit to justify reinstating development aid next year.

The commission, the European Union's executive branch, said that Budapest had "taken the necessary action" to correct its "excessive deficit" this year and that the deficit would remain below the E.U. limit of 3 percent of gross domestic product next year despite a "slight weakening" of the overall economy.

As a result, the commission said it would recommend that governments lift the suspension of nearly €500 million, or $625 million, in European funds.

"For Hungary, we consider that effective action has been taken," the European economic and monetary affairs commissioner, Olli Rehn, said.

In March, European finance ministers had suspended the aid, which is due to be paid in 2013, unless Hungary redoubled its efforts. It was the first time they had agreed to punish a member state for flouting the bloc's budget rules, reflecting its recognition that years of failing to do so had contributed to the current debt crisis in Europe.

Even so, the ministers agreed at the time to review the decision in June, underscoring the political sensitivities. Some ministers complained of a double standard, as the decision to suspend aid

**"We consider that effective action has been taken."**

to Hungary came a day after Spain was given more leeway to get its deficit under control.

The aid suspension added to Hungary's economic woes as it struggled to recover from the global financial crisis and economic downturn.

The country, which is outside the euro zone, has been seeking since November to open negotiations with the International Monetary Fund and European Union on its second bailout package. But the talks have been blocked by clashes between Brussels and the Hungarian prime minister, Viktor Orban, over new laws that raised questions about the strength of his government's commitment to democracy.

A month ago, the commission said it had accepted assurances that the Hungarian government was not undermining the independence of the central bank, and that it would seek an opinion from a European court on two other laws involving the judiciary and the media.

On Wednesday, the European Central Bank repeated its criticism of changes passed last year to the rules governing Hungary's central bank. The remarks did not, however, take into account amendments that will be considered by the Hungarian Parliament next week, Reuters reported from Budapest.

# Tighter coordination urged on euro zone policies

*EURO ZONE, FROM PAGE 1*

growth, and warned that Spain still had a long way to go to restore investors' confidence.

But Olli Rehn, the E.U. commissioner for economic and monetary affairs, said he would give Spain an extra year, until 2014, to meet its deficit targets as long as it continued to rein in spending by regional governments and presented credible budget plans.

In the case of France, the commission said the government would need to take significant steps to bring next year's budget deficit down to the E.U. limit of 3 percent of gross domestic product, a finding that may restrict the ability of Mr. Hollande to follow through on campaign promises to revive growth.

"Although this year's target of 4.4 percent of G.D.P. appears achievable, the distance to the 3 percent of G.D.P. threshold remains significant," said the commission, adding that Paris might need to make "additional efforts."

In the case of Greece, the commission said the country had made "mixed progress," hampered by "political instability, social unrest, issues related to administrative capacity and a recession that was much more severe than previously projected." Although it has "substantially reduced" its budget deficit since 2009, the commission said Athens should use the next several years, while supported by bailout money, to "underpin" the measures introduced.

In its report on the euro area as a whole, the commission said that issuing bonds jointly backed by all euro zone members, known as euro bonds, could help resolve the sovereign debt crisis that began in Greece but now has created spillover effects across the entire region.

In the short term, "creating a new market segment based on common issuance would address the current shortage of investor demand for the sovereign bonds of many euro area member states," the commission said, while cautioning that member states first had to tighten economic governance.

"The net effects of common issuance will be positive only if the potential disincentives for fiscal discipline can be controlled," the commission said.

The commission's assessments are part of the measures intended to fill that governance gap. It provided specific recommendations for each of the member states, which would become binding once endorsed by E.U. leaders at a summit meeting at the end of June.

The finances of the euro zone countries that have received bailouts — Greece, Portugal and Ireland — are already being monitored by the commission and their creditors, including the European Central Bank and the International Monetary Fund.

The commission has issued fiscal recommendations once before, in 2011, but this is the first year that member states face the prospect of severe penalties, including fines of up to 0.2 percent of G.D.P., if they fail to take steps to address the commission's concerns.

But there were signs that the commission was prepared to take into account a changing mood in Europe, signaled by the election of Mr. Hollande, who has emphasized the need for growth as a way out of the crisis, rather than rigorous austerity alone.

"The main challenge for fiscal policy is to pursue fiscal consolidation in a growth-friendly manner," the commission said.

It also argued against a one-size-fits-all approach.

"The size of fiscal challenge differs among the euro area member states and calls for differentiated speed of consolidation," it said.

In carefully guarded language, however, the commission sought to caution the new French president that the country's budgetary situation remained challenging, especially given "tensions" over sovereign debt.

SOTIRIS BARBAROUSIS/EUROPEAN PRESSPHOTO AGENCY

**Greek police officers scuffling Wednesday with protesters of plans to privatize Salonika's sanitation services. The commission gave Greece mixed marks for its budget policies.**

It said that the sustainability of the public pension system, which Mr. Hollande has vowed to review, "requires careful monitoring," and suggested that government payrolls needed to be cut, rather than expanded.

The commission's verdict could put pressure on Mr. Hollande to cut rather than increase public-sector employment at a time when labor unions have already warned him not to backtrack in other areas, including his pledge to reverse the previous administration's increase in the minimum retirement age. If Mr. Hollande shows signs of reneging on his campaign promises, it could weaken his Socialist Party in parliamentary elections on June 17.

**The commission has issued budget recommendations before, but this is the first year nations face severe penalties.**

The commission reserved some of its toughest messages for Spain, where Prime Minister Mariano Rajoy has vowed to reduce a budget deficit of 8.9 percent of G.D.P. last year to 5.3 percent in 2012 and 3 percent in 2013.

"Spain continues to face important policy challenges following the bursting of the housing and credit bubble," it said. "Further fiscal consolidation and fiscal discipline at regional level are necessary to restore market confidence and to halt the rapid increase in government debt."

The commission judged that some of the policies Spain had submitted "lack sufficient ambition to address the challenges identified." Regional governments are expected to miss their deficit targets and Madrid had so far failed to offer specific plans to rectify the situation, it added.

The report also criticized Spain's tax system, saying some of the new measures were "heading in the opposite direction" of what was recommended to lift growth, by adding to the burden on labor and capital.

The commission said that Spanish banks, which are sinking deeper into crisis in the wake of the government's costly bailout of Bankia, "may require further strengthening of the capital buffers of banks, especially of weaker institutions."

The report offered cautious praise for Italy. But it said more needed to be done to tighten public finances, and to change labor markets and taxation.

No country escaped criticism, not even Germany, which had a relatively robust economy in 2011 and has already surpassed its deficit-reduction targets.

The commission noted that the German economy would slow in 2012, though unemployment would continue to decrease, and criticized Berlin for not being more ambitious in its efforts to address looming problems like an aging population.

"Demographic change poses a major challenge for Germany's potential growth in the medium to long term," it said. Among its recommendations were measures to lift the participation of women and immigrants in the work force.

# Irish appear ready to pass E.U. treaty, but hostility remains

DUBLIN

BY DOUGLAS DALBY

Ireland appears poised to ratify in a referendum Thursday a European Union treaty designed to stabilize the euro by punishing member states that fail to adhere to strict budgetary constraints.

Opinion polls have consistently suggested a resounding victory for the treaty in a campaign that has failed to ignite the political passions seen in previous referendums.

Yet the polls have also shown that about a third of the electorate was undecided or would not vote, a harbinger of a low turnout.

Political commentators are attributing the relative apathy to the complexity of the issues involved and to the fact that the treaty has already been approved by more than half of the E.U. countries. It will be enacted in January no matter how Ireland votes.

Those in favor of the treaty argue that Ireland has little choice but to sign because to do otherwise would be send the wrong signal at a time when the country needs to show investors strong European credentials.

Rejection could also deprive Ireland of E.U. financing after 2013, when the country's current bailout program ends. Although the government argues that more aid will not be necessary, many economists say a second bailout looks likely given a stricken domestic economy and the government's inability to return to the bond markets.

"The issue we have to decide here is the best option for getting this country to recover, and the best option here is to vote yes," the deputy prime minister and Labour Party leader, Eamon Gilmore, said during an interview Wednesday.

"Nobody wants austerity," he said, "and the question is, How do we get out of it? To get investment into this country we have to show that there is a stable euro, that Ireland's relationship to the euro is strong. That's essentially what this treaty is doing."

An anti-austerity protest vote drives the campaign for rejection, which has been led by Sinn Fein and the Socialist Party, some trade unions and independent members of Parliament in Ireland. They say the government has adopted scare tactics, arguing that European financing would continue regardless of the result.

The final tally is not expected before Friday.

# If Spain needs rescuing, where will Europe find the money to foot the bill?

*SPAIN, FROM PAGE 1*

back conditions in return.

Economists estimate that if Spain were forced out of the bond markets by its high borrowing costs and had to rely on funds from Europe and the International Monetary Fund to survive, the cost could reach €500 billion over several years.

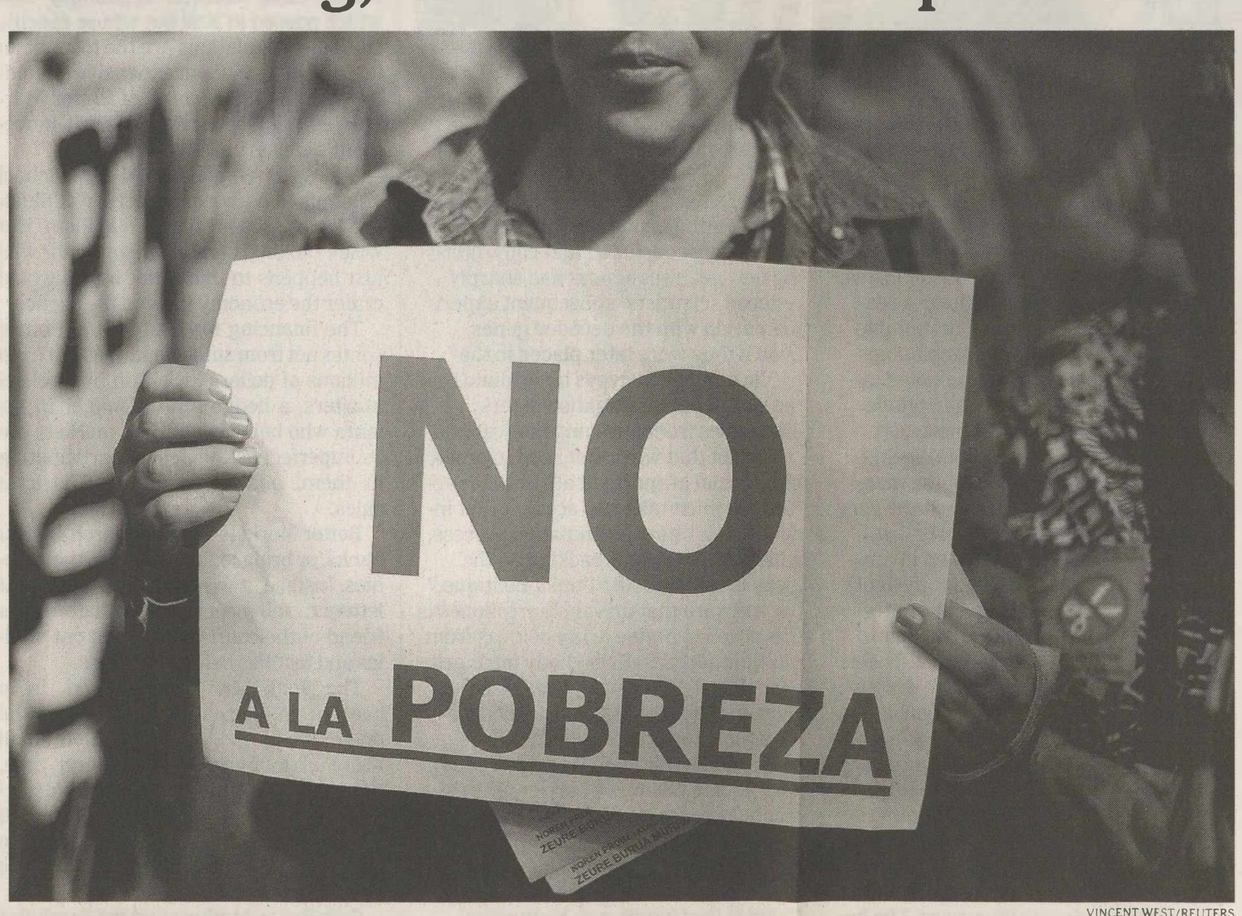
Europe's new bailout fund, the European Stability Mechanism, will have about €700 billion when it goes into operation this summer. But it remains untested in its ability to dispense money quickly and efficiently.

At the root of Spain's financing crisis has been a drastic outflow of foreign capital from the country — one that, paradoxically, has been accentuated by the European Central Bank's much-vaunted program of providing low-cost three-year loans to European banks so that they might buy their governments' bonds.

When the central bank created that program late last year, and dispensed two rounds of loans within a few months, it was credited with having done much to ease Europe's crisis fever.

But in the case of Spain, the program evidently bought time by making the country's underlying problems all the worse. Spanish banks have by far been the most aggressive participants in the cheap-loan program, having borrowed more than €300 billion from the E.C.B. And much of that money was spent on Spanish government bonds.

In the short term, those bond purchases helped the government by bringing down interest rates — in other words, by reducing Madrid's cost of borrowing. But as a result Spanish banks




VINCENT WEST/REUTERS

**A demonstrator in Bilbao objecting Wednesday to regional government cuts in social services spending. The sign reads, "No to poverty."**

now own a larger share, about 67 percent, of their own government's debt than the banks of any other country in the euro zone, according to research by BNP Paribas.

Now that those bonds are plummeting in value — prices fall as yields rise — Spain's banks and government are chasing each other in a financial tailspin.

In recent months, some of the biggest sellers of those bonds back to Spain's banks have been foreign banks and investors eager to take their money and run. In March, foreign bond investors owned only 26 percent of Spain's bonds, according to a recent analysis by J.P. Morgan, down from about 40 percent a year earlier.

Most analysts say they assume if that measure were made now, the foreign holdings would be even a smaller share of the total.

"There has been a great retreat here, and you can see it in the reduced foreign ownership of Spanish government bonds," said John Whittaker, an economist at Lancaster University in Britain who tracks capital flows within the euro zone.

Burdened as they are by problem loans from the collapse of Spain's real estate bubble, banks now have the additional onus of carrying large holdings of government bonds that are losing value by the day. Among the largest holders of Spanish bonds are the country's international banking giants Santander and BBVA, which, through February, owned €60 billion and €49 billion, respectively.

Given those big banks' diverse overseas operations and stronger capital positions, these holdings do not represent an immediate threat. But for Spain's many domestically focused banks, including bailed-out Bankia, which had €29 billion worth of government bonds as of last year, such exposures are more problematic.

It's not just Spain, either.

Italian banks have also been enthusiastic buyers of their government's bonds, and they own 57 percent of bonds outstanding. As in the case of Spain, foreigners have been obliging sellers and have sold €242 billion worth of bonds to local banks, bringing their share in Italian bond holdings down to 35 percent as of this March compared with 51 percent late last year.

It is worth noting that just before the restructuring of private-sector Greek debt in March, foreign investors owned 32 percent of the bonds outstanding, a higher proportion than what foreigners now own in Spain.

**Spain is fast eclipsing Greece as the focus of the euro zone's debt crisis.**

If Spain does eventually need to seek a bailout from the European Financial Stability Facility, it might have trouble meeting that fund's requirements. According to the facility's bylaws, money could be dispensed only if Spain met numerous conditions, most prominent of which are hitting budget deficit targets.

And on that score the news is not good at all. Through the first four months of this year, Spain's budget deficit was 26 percent higher than it was a year earlier, because of increased payouts to its debt-plagued regional governments, collapsing tax revenues and the soaring cost of unemployment benefits.

The prospect of Spain's bringing its deficit down from its current level of 8.5 percent, to the 5.3 percent target already set for this year by Europe, now seems unlikely.

"We are a highly leveraged nation," said Mr. Valverde, the economist. "What we need is a Europe-wide solution."

*Raphael Minder contributed reporting from Madrid.*

**REUTERS BREAKINGVIEWS**
Madrid should fix its financial problems by finally agreeing to borrow from E.U. stability funds and injecting the money into its struggling banks. *PAGE 18*