bune
GLOBAL.NYTIMES.COM

Bitter recipe from Berlin tests euro solidarity

PARIS

As borrowing costs climb, core nations questioning refusal to let E.C.B. help

BY LIZ ALDERMAN

Throughout Europe's long debt crisis, Germany has prescribed the same strong remedy to its troubled neighbors: a stiff dose of fiscal discipline.

As long as the patients were South European countries like Greece and Italy, seen as victims of an unhealthy lifestyle, northern-tier nations like France, Austria and the Netherlands have been willing to go along with Germany's prescriptions for reducing debt in the name of economic health. And they were willing to support Germany's insistence that the European Central Bank should not be a lender of last resort to indebted governments, by actively buying their bonds.

But suddenly, as investors' fears mount that many euro area nations are about to tip into recession, even countries like credit-worthy France are finding it much more expensive to borrow money in the open market, compared with Germany. And with that development comes a dawning realization: that austerity, rather than making it easier for them to pay down their higher debts, could make it harder — and more expensive.

As France's borrowing costs become increasingly divergent from Germany's, so might its attitude toward E.C.B. lending.

On Wednesday, Chancellor Angela Merkel of Germany continued to speak out against E.C.B. bond buying, while the French finance minister, François Baroin, was arguing just the opposite.

Mr. Baroin called for the support of all European institutions, including the E.C.B., to respond to the crisis. "But Germany, for historic reasons, has closed the door to the direct involvement of the E.C.B.," Mr. Baroin said in an interview with the French business newspaper Les Échos.

On Wednesday, the so-called yield gap — the premium that investors demand for holding French 10-year government bonds, rather than German ones — rose

EURO, PAGE 15

TONY GENTILE/REUTERS

ANNOUNCING ITALY'S NEW CABINET
The incoming prime minister of Italy, Mario Monti, appointed a group of experts on Wednesday. *PAGE 3*

THE MYSTERY OF THE STABLE CURRENCY
Many analysts are baffled that even though the euro zone is in crisis, the euro s still robust, Mike Dolan writes. *PAGE 16*

Bitter recipe from Berlin tests solidarity of euro zone nations

EURO, FROM PAGE 1

to a new euro-era high of nearly two percentage points. It later eased back somewhat, to 1.9 percentage points.

That is still not close to the yield gap of nearly 5.2 percentage points that beleagured Italy has with Germany, but it is a disturbing new trend for France. Austria and Netherlands are also experiencing widening yield gaps with Germany.

Mr. Baroin's remark was a reference to Germany's deep-seated fears over the inflation that could result from the E.C.B.'s pumping more money into the region's economies.

Italy continues to be a major source of bond-market jitters, despite the announcement Wednesday by its new prime minister, Mario Monti, of a new cabinet in which he named himself finance minister and brought in a number of academics and people from the banking industry and the upper reaches of the civil service.

Italian 10-year yields were back to nearly 7 percent Wednesday, the level at which analysts say financing the country's €1.8 trillion, or $2.4 trillion, debt mountain becomes unsustainable.

But the market anxiety has moved well beyond Italy, as the specter of a regionwide recession is making investors realize that if every country is tightening its belt at the same time, few will be able to grow their way out of the problems any time soon.

So far, France, the Netherlands and Austria have been among Germany's allies in the crisis. France, eager to show that the French-German axis is thriving, has even backed Germany's stance on E.C.B. lending. The question now, though, is whether other countries will start to resist Germany's policy prescriptions.

"The Germans have been able to rely on the French, the Dutch and the Austrians," said Simon Tilford, the chief economist at the Center for European Reform in London. "But if they get dragged into this and their borrowing costs continue to rise, that could influence whether they continue to back Germany and the line taken on the euro zone crisis."

On Wednesday, the French government showed a clear sign of divergence. It called on the E.C.B. to help calm the crisis by buying the bonds of Italy, Greece and other governments whose borrowing costs are surging. The E.C.B., in fact, has already been doing that, but at modest levels that seem to be having little impact.

"The E.C.B.'s role is to ensure the stability of the euro, but also the financial stability of Europe," Valérie Pécresse, the French budget minister, said Wednesday. "We trust that the E.C.B. will take the necessary measures to ensure financial stability in Europe."

Mr. Baroin, the French finance minister, went farther, alluding to the German fear of inflation, which many historians say helped Adolf Hitler's rise to power. Indeed, much of Germany's response to the current economic crisis is rooted in a desire not to let history repeat itself.

Mr. Baroin noted that the U.S. Federal Reserve and the Bank of Japan have intervened in their bond markets with little fear that they are being influenced politically. "But Germany has a history, a memory about inflation and overindebtedness," he said.

The E.C.B. is also being sought out by banks that are despearate for cheap funding to offset losses brought on by the sovereign debt crisis. The chief executive of Unicredit, one of Itlay's largest lenders, on Wednesday urged the European Central Bank to increase access to E.C.B. borrowing for Italian banks, the Italian press reported.

That is a sign that the bank is having trouble raising capital in difficult market conditions, and needs all the support it can get, said David Thébault, head of quantitative sales trading at Global Equities in Paris.

As France's borrowing costs become increasingly divergent from Germany's, so might its attitude toward E.C.B. lending.

Berlin fears that allowing countries to rely on the E.C.B. as a white knight in the crisis would make them lazy about fixing their own finances. On Monday, Jens Weidmann, president of the German Bundesbank and an influential member of the central bank's governing council, said Monday it would be illegal to use the central bank to solve government budget problems.

"The increasing demand being placed on monetary policy is dangerous," Mr. Weidmann said in a speech. "Monetary policy cannot and may not solve the solvency problems of governments and banks."

Analysts, though, say the time for implementing ideology is quickly running out. Because European policy makers have still not started up the main bailout fund for Europe — the European Financial Stability Facility — there are virtually no other tools besides austerity to whittle down debts and deficits.

But, says Mr. Tilford, the euro zone "is going to crack unless E.C.B. enters the picture soon." If the central bank really starts carrying out the lender of last resort function, then the crisis can still be reined in, he and others said.

The question is whether the E.C.B. is engaging in strategy of brinkmanship to extract as many reforms from governments before it intervenes, or whether it genuinely intends to resist pressure to be a lender of last resort.

"If it's a game of chicken, then it's a very risky one," said Mr. Tilford. "If they are resisting becoming a lender of last resort, then the future of the euro zone is very much in doubt."