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Politicians may accept tighter union

Paul Taylor

INSIDE EUROPE

BRUSSELS The euro zone is staring into the abyss.

Unless European leaders agree on a political remedy for their sovereign debt crisis at a summit meeting Dec. 9, and the European Central Bank then intervenes on a vast scale to support government bonds and European banks, the euro may start to unravel.

Foreign investors are already shunning sovereign bonds from the euro area; European banks are desperately trying to sell assets including bonds; depositors are withdrawing growing amounts from south European banks; and interbank lending is freezing up, requiring ever more lenders to turn to the E.C.B. for funds.

Italy, the most vulnerable state in the euro zone, has a mountain of debt to refinance, and its short-term borrowing rate hit an alarming 8 percent Friday.

Josef Ackermann, chief executive of Deutsche Bank and chairman of the Institute of International Finance, the world banking lobby, delivered a stark message last week to Herman Van Rompuy, the European Council president, according to a person familiar with the conversation.

Allowing political indecision to continue into the new year would risk a drastic worsening of the crisis on financial markets, Mr. Ackermann warned Mr. Van Rompuy and other E.U. officials.

Major banks like BNP Paribas and ING announced disposals of sovereign debt this month. BNP, a French lender, disclosed it had dumped €12.6 billion, or $16.8 billion, in Italian, Spanish, French and German bonds over four months. ING, a Dutch bank, said it had cut Greek, Italian, Irish, Portuguese and Spanish sovereign holdings €5.4 billion.

Germany, the European creditor in chief, has seemed oblivious to distress calls for emergency action and is pursuing a single-minded strategy of changing the European Union's treaty to entrench tougher fiscal discipline.

Chancellor Angela Merkel, determined to prevent countries from living beyond their means at German taxpayers' expense, has decided the answer to the crisis is closer fiscal union among the 17 states in the euro zone.

She and her aides are using the raging market turmoil to strong-arm Berlin's partners into accepting new powers to override the national budgets of euro zone states that go off the rails and, if necessary, to take them to court and punish them. Under the German plan, the European authorities would exercise ultimate control over national debts and deficits, with the right to make parliaments revise budgets that breach E.U. rules.

"The Germans are playing the hardest of hardball," said a French official involved in the negotiations.

Countries like France, traditionally attached to national sovereignty, have little alternative but to swallow the German demands for treaty change, since their own borrowing costs are rising and their top-notch AAA credit rating is under threat.

President Nicolas Sarkozy, whose hopes of re-election next year effectively hinge on the euro zone crisis, has little to show so far in return for his concessions to Berlin.

Allowing political indecision to continue into the new year risks a drastic worsening of the crisis.

Last week, Mrs. Merkel publicly doused French hopes for a trade-off in which Germany would give a green light for much bigger E.C.B. bond-buying or would agree to issue common euro zone bonds.

"This is not about give and take," she said after they met in Strasbourg last week, insisting she had not changed her position on the central bank, which is that the E.U. treaty bars it from funding states, or on joint debt issuance.

Germany, haunted by the experience of hyperinflation in 1923 and after World War II, is deeply fearful of debauching the central bank by printing money to lend to governments.

Jens Weidmann, the president of the German central bank and a powerful influence on the E.C.B. governing council who speaks for Germany's conservative financial establishment, keeps warning against overstretching the E.C.B.'s mandate and compromising its independence. Mr. Weidmann, like Mrs. Merkel, now accepts the principle of jointly issued euro zone bonds as a long-term goal of a fiscal union, but "only at the end of an integration process" that entrenches central control over member states' budgets.

Senior E.U. and E.C.B. figures, who spoke privately because of the sensitivity of the issue, said there was an understanding that if Europe's political leaders took a big step toward such a fiscal union Dec. 9, the E.C.B. would have grounds to intervene more decisively. Some saw the agreement between Mr. Sarkozy and Mrs. Merkel to refrain from making "either positive or negative demands" on the E.C.B. as an attempt to clear the way by stifling political pressure.

A deal on moving toward fiscal union is not yet certain, and markets, which hate uncertainty, may well feel the tortuous process of treaty change creates more political risk than it removes.

But if it gives the E.C.B. a pretext for unleashing its hefty financial firepower to defend euro zone government bonds, desperate European politicians may have to embrace it.

One important unknown is whether all 27 E.U. states will agree to amend the treaty, or whether a separate accord will have to be struck among the 17 euro zone members, or a smaller inner core, cementing the existence of an awkward two-speed Europe.

Noneuro Britain may seek to impose its own demands to repatriate control over some social and legal policies, or a veto right on E.U. financial services legislation, as its price for letting a euro area fiscal union advance.

Several governments are deeply reluctant to start down the avenue of treaty change, either because they oppose ceding more national sovereignty, or because they fear losing parliamentary votes or referendums on the outcome.

Many dread the prospect of long months of ratification roulette, with markets in a frenzy as Europe's future hinges again on a vote in a small country like Ireland or Slovakia.

But if a promise of fiscal union is the only way to bring about E.C.B. action to pull the euro zone back from the abyss, European political leaders are likely to swallow their misgivings and take the pledge.

Paul Taylor is a Reuters correspondent.

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