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Debt crisis could be good news for Merkel

BERLIN

Chancellor has chance to urge others to adopt Germany's rigorous lead

BY NICHOLAS KULISH

As so often during the European debt crisis threatening the very existence of the euro, seemingly bad news from the financial markets was in reality good news for Chancellor Angela Merkel's effort to remake the euro zone in Germany's rigorous likeness.

Throughout, Mrs. Merkel has pur-

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sued a strategy of brinkmanship. Instead of acting quickly to stem market panic and restore investor confidence, she has used the pain of soaring borrowing rates to win enforceable rules requiring budget discipline of all 17 European Union countries that use the euro.

Mrs. Merkel reacted to the stunning warning from Standard & Poor's that it might lower the credit ratings of 15 euro-zone countries, including Germany, with defiance.

"What a rating agency does is the responsibility of the rating agency," she told reporters on Tuesday in Berlin.

The ratings announcement seemed almost welcomed as a spur to change European treaties along lines proposed hours earlier by Mrs. Merkel and President Nicolas Sarkozy of France before this week's summit meeting in Brussels.

As Mrs. Merkel's finance minister, Wolfgang Schäuble, put it on Tuesday at a news conference in Vienna, "The decision by Standard & Poor's is the best incentive for the heads of government and state this coming Friday to do what they have promised." Leaders need to make "the necessary decisions to bring back the confidence of financial investors step by step," he said.

To American officials Mrs. Merkel, 57, seems at times shockingly impervious to the fluctuations of markets. She is in nearly daily contact with worried officials in the United States. Even as she deflects their demands for more aggressive action, she has kept the Obama administration hopeful that she will master the crisis — maybe with at least tacit approval for the European Central Bank to step in more forcefully.

The U.S. Treasury secretary, Timothy F. Geithner, flew to Germany on Tuesday, meeting first with the president of the European Central Bank, Mario Draghi, and the German central bank president, Jens Weidmann, before spending an hour with Mr. Schäuble at the Finance Ministry in Berlin. Mr. Geithner said he was "very encouraged by the developments in Europe in the past few weeks."

If Mrs. Merkel sets the euro on the path to greater stability and deeper integration of the economies that issue it, she will win most of the credit. But many economists say that she embodies Germany's too little too late approach, and will reap the blame for presiding over the collapse of the euro and its untold consequences.

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E.C.B. seen cutting rates, but stronger steps limited

FRANKFURT

While new chief pushes to address flaws in euro zone, obstacles are high

BY JACK EWING

For someone with a reputation for caution, Mario Draghi is off to an audacious start as president of the European Central Bank. Since taking office little more than a month ago, he has presided over an interest rate cut, signaled a greater willingness to deploy E.C.B. resources to fight the European debt crisis, and turned up the pressure on governments to remake the euro zone.

More action is likely Thursday when the bank's policy council meets. Analysts expect another cut, perhaps a big one, in the bank's benchmark interest rate, currently at 1.25 percent.

The E.C.B. is also expected to start offering longer-term loans to banks to compensate for a flight from European financial institutions by private lenders. And Mr. Draghi is likely to re-emphasize the tacit bargain he offered political leaders last week: The central bank would temporarily stabilize financial markets if the politicians make concrete progress on fixing the structural flaws in the euro zone.

Mr. Draghi, businesslike and direct in his public statements so far, seems unencumbered by past policy moves and determined to take the initiative before the strains of the crisis exhaust him, as they sometimes seemed to have worn on his predecessor, Jean-Claude Trichet.

While Mr. Trichet remains an esteemed figure in Europe, with a legendary stamina, three years of nearly nonstop crisis management took their toll in his final months in office. For now, at least, Mr. Draghi appears fresh and unafraid of putting his own stamp on policy.

"Draghi can say different things," said Marie Diron, an economist in London who advises the consulting firm Ernst & Young. "People won't say, This is not what you were saying a few months ago. It makes a change of policy, a bit of U-turn, easier."

But will it be enough to satisfy the large body of economists and political leaders who contend that the crisis endgame will have to include much more aggressive and controversial action by the E.C.B.?

Guntram B. Wolff, deputy director of Bruegel, a research organization in Brussels, argues that the E.C.B. may have no choice but to become lender of last resort to governments and not just banks, as the only way to prevent market panics that drive up borrowing costs for countries like Italy.

"A lender of last resort needs to be created in order to stop self-fulfilling sover-

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S.& P. WARNING RILES E.U. LEADERS
Many in Brussels were angered by the threat of a credit rating downgrade days before a crucial meeting. *PAGE 15*

ECONOMIC WOES SPREAD EAST
Interest-rate cuts and lower growth estimates show that U.S. and European debt problems are affecting Asia. *PAGE 16*

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Euro plan is reckless, but needed

James Saft

INSIDE THE MARKETS

Call it the Merkozy Plan — there shall be no more losses.

On Monday, Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France presented yet another final plan to save the euro. This time, they called for new treaty provisions to ensure that members maintain fiscal discipline, along with an all-too-predictable proposal to hold monthly meetings of E.U. heads, seemingly an attempt to revive Europe by providing business for its caterers.

Perhaps most important, the two agreed to scrap a previous agreement to make private-sector creditors share in the losses in all future bailouts.

Bondholders still face a 50 percent write-down on their holdings of Greek debt, but that is it; it is all going to come out of the hides of taxpayers.

Of course, there is the slim possibility that future bailouts will include burden-sharing by banks and others who hold European government bonds, but given how poorly that was received this time, it is best not to hold your breath.

The U-turn is wise, reckless and deeply depressing all at the same time.

Wise because there is a direct line of causation between the imposed Greek write-down and the subsequent big sell-off in Italian bonds. Investors are capable of imagining the future, and as the future they saw included no guarantee for them, then Italian bonds were toxic.

''It was a terrible mistake,'' Athanasios Orphanides, a member of the European Central Bank's governing council, said. ''By forcing the impairment of any state bond, we have triggered concern internationally of all state bonds in the euro zone, and that's one of the key reasons we have a problem,'' said Mr. Orphanides, the Cypriot central banker.

Those sales of bonds threatened to make failure by Italy a self-fulfilling phenomenon, as the higher the interest rate went, the less solvent Italy became. With the rot spreading into Belgian and French bond markets and with some German bonds trading at levels that make sense only if investors expect them to be redenominated in new Deutsche marks, a change in policy was inevitable.

This idea of private-sector participation in bond losses, which is of course basic to a market-based system, is tough to extinguish. If the International Monetary Fund becomes the vehicle for financing the bailout, it will want to be the senior creditor.

The move is reckless because in pinning all of the costs of the bailout on the public purse, which is the only possible source of funding now, Mr. Sarkozy and Mrs. Merkel have managed only to underline exactly how vulnerable Europe's finances are.

Standard & Poor's has warned 15 euro zone nations that they risk a downgrade. This makes perfect sense, as a move to absolve private-sector creditors from their share in losses only increases the burden on those better-rated countries.

From now on, bondholders won't face any losses if a country needs to be bailed out.

The reversal is also reckless because the U-turn only further institutionalizes the tacit policy that banks will not be made to absorb the consequences. While it is good that Europe is taking steps to prohibit countries from excessive borrowing, the banking system will find other reckless loans to make. A bond market without losses is nonsense. The next crisis starts here.

It is deeply depressing because we are faced with two likely alternatives: a cataclysmic fracturing of the euro or insufficiently democratic policy-making. Given German, Austrian and Finnish distaste at bailouts — of investors and countries — it seems unlikely that the proposed treaty changes will be put to a popular vote everywhere.

Because the treaty changes imply a loss of sovereignty, this is quite short of the sort of thing that ought to happen in a full, participatory democracy.

It is hard to be in favor of bailing out feckless investors, and even harder to countenance major changes in government without sufficient public participation. But at this point, it is harder, perhaps, to devise an alternative.

James Saft is a Reuters columnist.

Crisis could be Merkel's opportunity to model euro zone after Germany

MERKEL, FROM PAGE 1

This steely champion of austerity has won the reputation around Europe for demanding punishing reforms and cutbacks in the name of a stable future for the euro. In the process, she has acquired the nickname of her 19th-century predecessor Otto von Bismarck: The Iron Chancellor.

She has proven adept at juggling divergent interests at home, where the German people do not want her offering any more guarantees of taxpayer money to combat the debt crisis, and abroad, where they are begging her to do so. She has kept the strict Finns and Dutch in line while pressing for reforms from the likes of Mario Monti, Italy's new technocratic prime minister.

Her leadership has come at a high cost for other countries, with cuts in public spending biting just as joblessness has surged. Youth unemployment in Spain is nearly 50 percent, a fact she raises with audiences at home as she cautiously sells more intervention.

The treaty changes she and Mr. Sarkozy proposed in Paris on Monday would have been inconceivable at the outset of the crisis, requiring states to cede unprecedented degrees of economic sovereignty. Many analysts, in particular those among the populist British press, paint German dominance of the euro zone as firmly in place — with Mrs. Merkel as the unofficial, unchallenged leader of Europe.

Silvio Berlusconi's resignation as Italy's prime minister has been seen by many as an omen of Europe's German-directed future. Meanwhile, confidential draft proposals of Ireland's December budget circulated last month among lawmakers in Berlin before opposition lawmakers in Dublin saw them.

Despite her global prominence, Mrs. Merkel, who was an East German physicist, cuts a modest figure. She still lives with her media-shy second husband, a quantum chemist, in the same apartment across from the Pergamon Museum, in central Berlin, where she did before becoming chancellor. Her daily commute to the modern Chancellery building carries her across the former path of the Berlin Wall, a reminder of her years trapped behind it.

On the desk in her eighth-floor office sits a small portrait of Catherine the Great. The German news media often have compared the way Catherine deposed her husband to Mrs. Merkel's forcing her benefactor, Helmut Kohl, out as leader of the Christian Democrats. What they shy away from is that the czarina expanded the Russian empire by about 520,000 square kilometers, or 200,000 square miles.

"The decision by Standard & Poor's is the best incentive for the heads of government and state this coming Friday."

A routine day for Mrs. Merkel in Berlin illustrates the demands on a woman who has become the fulcrum of the financial future, but still is a member of Parliament and party leader.

On Friday morning, she spoke in the Reichstag building, and compared the steps to strengthen the euro zone to a marathon.

When chuckles and chatter rose from the ranks of the opposition Green party, Mrs. Merkel looked up from her notes, glared at the murmuring Parliament members and said: "It appears to be incredibly funny to the Greens. To me it's incredibly logical. That's just the difference." She continued. When the official transcript of her speech appeared, the withering aside was absent.

The speech over, with the cameras off her for a moment, Mrs. Merkel yawned and slumped slightly in her chair, a rare down moment. Soon, she was holding a series of whispered discussions with the economy minister and vice chancellor, Philipp Rösler, and Mr. Schäuble, her finance minister.

Her staunchest critics point to what they call a worrying distrust of financial markets on the part of the chancellor, and a lack of market expertise among ministers and advisers. Mr. Schäuble is a lawyer by training and Mr. Rösler a medical doctor. Since Mr. Weidmann, her chief economics adviser, left to head the German central bank, she has relied on Lars-Hendrik Röller, an academic who once headed the competition authority in Brussels.

After an hour and a half of working the room, she left the chamber. Mrs. Merkel had to record her weekly podcast — this time, on energy efficiency — and prepare for the chancellor of Austria, Werner Faymann. The two talked budgets and bailouts over beef roulade in the Chancellery's penthouse dining room, joined by the governor of the Austrian National Bank, Ewald Nowotny, Mr. Röller and others.

TOBIAS SCHWARZ/REUTERS

The U.S. Treasury secretary, Timothy Geithner, left, and German finance minister, Wolfgang Schäuble, met Tuesday in Berlin.

Following a news conference with Mr. Faymann, the world's most powerful woman climbed into a black Audi sedan and went to the headquarters of her political party, the Christian Democratic Union. She hustled past copies of the magazine Schlesien Heute and the weekly Sudetendeutsche Zeitung to address the party's East and Central German Association, elderly survivors — and their heirs — of forced migration from lost German territories after World War II.

With the ease of a big-city mayor stroking local constituents, Mrs. Merkel dropped in a reference to the association chairman's margin of re-election. She thanked members by name for their work. In honor of the honorary chairman, Sieghard Rost's recent 90th birthday, she presented him with a book of her speeches, "Words of Power."

Before the crisis began, some saw Mrs. Merkel as a caretaker chancellor, a politician who liked to give voters what they wanted and preferred not to create waves. "Perhaps a few of us thought that after German unification there would not be so much more to do," Mrs. Merkel told the audience of expellees. "We were wrong there."

Annie Lowrey contributed reporting.

E.C.B. rate cuts seen, but not stronger steps

E.C.B., FROM PAGE 1
eign crises,'' Mr. Wolff wrote Monday. ''Interest rates paid on sovereign bonds in a number of countries are clearly the result of self-fulfilling crisis, which will ultimately force default even on a country like Italy, with devastating consequences for the euro area as a whole.''

For all his differences in tone, Mr. Draghi also inherits the tensions that made Mr. Trichet's tenure so difficult, including a mandate that did not anticipate the kind of crisis now threatening the European and global economies. And he faces, as Mr. Trichet did, determined opposition from Germany to any expansion of the E.C.B.'s writ beyond a single-minded focus on price stability.

Mr. Draghi last week tacitly offered to intervene more aggressively in bond markets to keep interest rates under control in countries like Italy and Spain, if euro zone governments did more to discipline their members. But it is not yet clear what he meant by that.

Would the E.C.B. simply expand its existing bond buying in a modest way? Or would it cross the Rubicon and buy securities on a scale that would amount to significantly enlarging the money supply? He did not say.

In any case, the reaction in Germany to Mr. Draghi's remarks was swift. Jens Weidmann, the president of the German central bank, said he remained stalwartly opposed to more bond market intervention, which he regards as an illegal transfer of debts from one country to another. Mr. Draghi risks straining the unity of the euro zone if he radically steps up E.C.B. purchases of government bonds over the objections of Germany, the European Union's largest member.

Jörg Krämer, chief economist at Commerzbank in Frankfurt, expressed a sentiment widely shared in Germany. ''Huge purchases of government bonds in the euro zone threaten to shatter the monetary system,'' he wrote Monday in a note to clients.

Opponents of E.C.B. bond buying argue that it is actually far riskier than securities purchases made by the U.S. Federal Reserve. The Fed has bought far more paper: $2 trillion versus €207 billion, or about $277 billion, by the E.C.B. But while the Fed's purchases have included large amounts of U.S. Treasury securities, which remain an international haven, the E.C.B. has bought mostly bonds from troubled countries like Greece and Portugal, becoming what critics say is a storehouse for distressed government debt.

For the time being, the E.C.B. is expected to continue buying bonds in relatively modest amounts, perhaps increasing the volume if euro zone leaders reach a serious deal at the summit meeting scheduled to begin hours after the E.C.B. policy-making session on Thursday. More aggressive action is possible then, perhaps a declaration by Mr. Draghi that the E.C.B. would not tolerate yields on Italian and Spanish government bonds above a certain level, intervening when necessary to drive down borrowing costs.

The E.C.B. could also stop trying to offset the potentially inflationary impact of its intervention, no longer draining as much money from circulation as it adds by buying bonds. At that point, the E.C.B. would be effectively printing money, something that many economists say would be a good thing when growth is disappearing and inflation is starting to shrink.

"A lender of last resort needs to be created in order to stop self-fulfilling sovereign crises."

But don't look for anything so ambitious yet. On Thursday, Mr. Draghi is likely to find a consensus in favor of less controversial anti-crisis measures, including a cut in the benchmark interest rate to 1 percent from 1.25 percent. That would reverse rate increases made earlier this year on Mr. Trichet's watch. The E.C.B. may even cut the rate to 0.75 percent, the lowest ever, some analysts say.

The rate cuts would help address increasing signs of a credit crunch in countries like Portugal and Italy, which cannot hope to grow again if businesses and consumers cannot get loans. Analysts at Royal Bank of Scotland estimate that borrowing costs for companies in Portugal rose nearly a percentage point from May to September, and by half a percentage point in Italy.

Mr. Draghi is also likely to receive broad support on the governing board for expansion of the unlimited loans that the E.C.B. offers to euro zone banks. So far, the E.C.B. has lent money for a maximum of 13 months. By offering credit for as long as three years, the E.C.B. would help banks that have been unable to sell bonds on the open market, and are running short of funds to lend to customers.

In addition, the E.C.B. may loosen its standards for collateral that banks must provide to get central bank loans. That would be a way to ease pressure on banks that have lots of assets that are hard to sell on the open market. For example, the E.C.B. could accept securities denominated in dollars or other foreign currencies as security, as it did after the financial crisis began in 2008.

JOCK FISTICK/BLOOMBERG NEWS

Mario Draghi, left, with Jean-Claude Juncker, leader of the euro zone finance ministers.

The E.C.B. is still a long way from quantitative easing, the wholesale purchase of government bonds and other assets in a deliberate attempt to revive the economy. Analysts say such a move would come, if ever, only after the E.C.B. had cut rates close to zero and inflation fell below the bank's target of 2 percent.

In that case, quantitative easing might be the only tool left to avoid deflation and the threat of years of stagnation. The E.C.B. would justify its action as a response to falling prices and not as a bailout of Italy or another country, which policy makers regard as a violation of the bank's mandate.

''This policy tool can be deployed if and only if the E.C.B. has used all its conventional tools and yet the risk of deflation still outweighs that of inflation,'' analysts at Royal Bank of Scotland wrote Monday in a note. ''This might happen at some stage in the future but is not the most pressing issue at the moment.''