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Celebration succumbs to concern for euro zone

PARIS

Ratings services warn that pact failed to resolve causes of peril for banks

BY LIZ ALDERMAN

The initial euphoria surrounding the deal by European leaders last week to strengthen the euro zone quickly gave way to a darker mood Monday, as ratings agencies warned that the European sovereign debt crisis remained at a critical stage that policy makers would find difficult to contain.

In European trading and on Wall Street, shares fell sharply after Moody's Investors Service and the Fitch Ratings warned that European efforts to protect the common currency had not resolved the immediate dangers of a significant economic downturn and troubles in the banking system.

By taking a "gradualist" approach to forging a true fiscal union among the 17 euro zone members, politicians were imposing additional economic and financial costs on the region, Fitch warned. "It means the crisis will continue at varying levels of intensity throughout 2012 and probably beyond, until the region is able to sustain broad economic recovery," the agency said.

Moody's said it was putting the sovereign ratings of European Union countries on review for a possible downgrade in the coming months. Standard & Poor's issued a similar warning last week, saying it could lower the sterling credit ratings of Germany and France and cut other countries' credit scores as Europe headed into a probable recession next year.

On Monday, President Nicolas Sarkozy of France acknowledged that a loss of the nation's triple-A rating could come soon, but said it would not pose an "insurmountable" difficulty. Mr. Sarkozy has made it a priority of his coming presidential campaign to keep the country's top credit rating, and repeated a pledge to reduce the nation's debt and deficit without cutting wages and pensions.

Mr. Sarkozy's rival, the Socialist candidate François Hollande, said Monday that he would try to renegotiate the terms of the Europewide deal struck Friday if he were elected president in May, saying the pact would stifle growth.

With markets and rating agencies expressing mild disappointment with the deal, the spotlight returned to the European Central Bank, the only institution with overall responsibility for maintaining the health and integrity of the euro.

Amid last week's political theater, the E.C.B. took a crucial step to help prevent the biggest European banks from succumbing to an increasingly volatile economic and market environment by agreeing to provide banks with unlimited funds for up to three years.

"That reduces the possibility of a Lehman moment quite substantially," Jacob Kirkegaard, a senior fellow at the Peterson Institute for International Economics in Washington, said during a

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Cameron defends veto and vows to stay in E.U.

LONDON

With coalition partner absent at Parliament, he says he protected Britain

BY SARAH LYALL

Prime Minister David Cameron moved vigorously Monday to defend his decision to veto the proposed treaty changes at the European summit meeting last week, telling Parliament that he had acted to protect Britain's interests and that, contrary to criticism, he had not consigned the country to the sidelines of Europe.

Members of the Labour opposition shouted out "Where's Clegg?" — a reference to Deputy Prime Minister Nick Clegg, Mr. Cameron's coalition partner, who, angry at the veto, was conspicuously absent from Parliament.

Mr. Cameron seemed at pains to offer soothing words to those afraid that he had so alienated his European allies that Britain was bound to leave the European Union altogether.

"Britain remains a full member of the E.U., and the events of the last week do nothing to change that," Mr. Cameron said. "Our membership of the E.U. is vital to our national interest. We are a trading nation and we need the single market for trade, investment and jobs."

After vitriol poured out at Mr. Cameron over the weekend — from the Labour Party, from prominent members of Mr. Clegg's Liberal Democratic Party and from European diplomats — the session Monday was oddly anticlimactic.

Mr. Cameron, buoyed by the compliments of anti-European backbenchers in his Conservative Party, who said they would have vetoed the treaty if he had signed it, appeared relaxed and self-assured, exuding the easy confidence that is one of his strongest political assets.

He told Parliament, as he has said all along, that he had exercised Britain's veto because the proposed treaty changes gave no assurances to safeguard the future of London's financial

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LEON NEAL/AFP

David Cameron exuded the easy confidence Monday that is one of his assets.

FOR U.K. LEADER, A VICTORY COULD SOUR
Prime Minister David Cameron has stumbled badly by demanding special treatment, Paul Taylor writes. *PAGE 24*

E.U. BANKS PASS ON PAIN TO CLIENTS
European banks are selling assets and raising customers' interest rates to bolster their balance sheets. *PAGE 22*

PAGE TWO

E.U.'s future: No war, but no growth

John Vinocur

POLITICUS

BRUSSELS Just about 15 years ago, Martin Feldstein, the Harvard economist and former adviser to Ronald Reagan, wrote that the coming of a common currency to Europe promised "incompatible expectations about the sharing of power." There were future conflicts in play, he argued, making an intra-European war "too real a possibility to ignore."

Over-the-top, Reaganite musings, some said. Neither the great bang of war nor its whimpers has materialized.

Still, without a shot being fired, Europe and its project to achieve power and greatness is in many ways demoralized, even devastated.

After another in a series of debt and deficit crisis summit meetings last week, the European Union, still uncertain about eliminating the markets' disbelief in its probity, has locked itself into a survival plan that turns the euro zone's back on growth to seek stability alone.

Europe and its project to achieve power and greatness is in many ways demoralized.

The results of the decision: A perspective of stagnation as the culmination of 18 months of fibbing and stalling about Europe's financial and economic reality that markets saw through and may continue to doubt. And a gap in enthusiasm (in truth there is none) between the E.U.'s common currency and its citizens — a Brussels official describes Europeans regarding the euro as a "convenience" rather than a necessity — at a moment when the euro zone's leaders have chosen to confront a likely recession with savings and rigor but no parallel plan for a surge in activity.

This is a Europe so diminished that it needs an entirely new narrative, according to Gerhard Schroder. (The former German chancellor turned Gazprom P.R. man has as unsurprising remedy to offer — an official association with Russia.) And it is a Europe where Germany appears so dominant that a more beloved former leader, Helmut Schmidt, has appealed to it to "show heart" to its neighbors.

Chancellor Angela Merkel makes the concession that Europe's pussy-footing (she speaks of delays) on the debt issue has cost it severely in terms of credibility. That may be an understatement.

In a conversation, a counselor to a European counterpart of the chancellor, who also supports the austerity pact, nonetheless defined the loss in credibility as bordering on "contempt" in China and the United States.

Mr. Feldstein's war, of course, has not occurred, and the achievements of the E.U.'s common currency are real. But he had a sharp sense for trouble.

Back in 1997, the central incompatibility that he feared involved "a French aspiration of equality and a German expectation of hegemony." Among the inconsistencies or conflicts Mr. Feldstein identified were Germany's fixation on price stability as opposed to France's will to have growth (he referred to it as "short-run macroeconomic expansion") as part of the euro's official creed.

An initial result was that in the run-up to the euro, the founding German stability concept became, at France's insistence, the Stability and Growth Pact, which, as 2011 has demonstrated, has not produced either commodity in world-beating proportions.

Arguably, because Europe failed to make labor market reform its cutting edge for change, Europe's experience with growth programs has been grim. Five years after it began in 2000, parallel to the euro's introduction, the E.U.'s Lisbon Agenda, aiming to make the community "the most complete and dynamic knowledge-based economy in the world," had faltered, and in 2010 was officially acknowledged as inadequate.

This year, as a result of the debt crisis — which Mr. Feldstein's scenario hadn't foreseen — the French flip-flopped.

Because of the fears of President Nicolas Sarkozy that his country would lose its handhold on an appearance of shared power with Germany, France dropped its insistence on the centrality of growth. Instead, Paris attempted to achieve budgetary targets allowing it to keep pace with those of the Germans.

This was the same Mr. Sarkozy who earlier in his term said he saw nothing wrong with quantitative easing (roughly, the equivalent of a central bank's increasing the money supply), and whose finance minister at the time, Christine Lagarde, now managing director of the International Monetary Fund, complained that the export surpluses of Germany's economic success were built on the deficits of other E.U. countries.

Her unheeded recommendation: Berlin should raise wages to increase domestic demand.

So: The E.U.'s situation about a decade after the coming of the euro is, no war, but no hard-wired plan for growth. And now, after the French fade, an absence of any member standing up as expansion's advocate while the chancellor talks about a marathon of "stabilizing" to last a decade.

Last Friday, while the Bundesbank was lowering to 0.6 percent its 2012 projection for German growth, and Mrs. Merkel was trumpeting Europe's new "stability union," I talked to Felix Huefner, of the Organization for Economic Cooperation and Development, about how Germany, Europe's putative locomotive, might fare in the next decade.

"The best you can hope for," he said, "is to replicate the previous 10-year cycle" — which by my calculation is a growth rate of 1.5 percent, hardly locomotive stuff, although Germany can live with it, even if it is just a couple of labor disruptions' distance from stagnation.

The Financial Times Deutschland, German-owned and German-edited, had this to say about the resulting situation: the chancellor was "sentencing other countries in Europe to short- and middle-term consolidation that points to a disaster."

That's hardly an endorsement of German leadership. It suggests no more reliability than Mrs. Merkel's 2011 decisions to avoid participation with her NATO partners in their Libyan intervention, or to suddenly abandon nuclear power in hopes of winning (an eventually lost) regional election.

Is there a prospect that an austerity-only plan for Europe can inspire, hearten, or engage ordinary folks? Or, when it comes to international ambitions, subtracting Britain's engagement, convince the G-2 of the United States and China that the European Union is a rising power, no matter hard or soft, and ready for pillar status in a supposedly (you could choke from laughing) multipolar world?

A more likely assumption for 2012: Europe stays seriously wounded.

Martin Feldstein, who picked up in 1997 on its incompatibilities, went further in commenting a few weeks ago, "The euro may soon collapse even though there is no fundamental reason for it to fail."

No war, but no growth or its prospect. That may be reason enough.

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TOMORROW: *Luisita Lopez Torregrosa on the impact of high-earning women.*

Markets test Europe's solution to crisis

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conference call on the crisis. "It says to every bank in the euro area that even if you're shut out of the market, we are the lender of last resort and provide you with necessary funding."

While that may ease the pressure on the financial system, any further downgrade in the credit rating of European governments could raise the fever of the crisis by making it more expensive for the weakest countries to service their debts. It could also make it more difficult for banks in Italy, Spain and even France to get credit from other banks, causing a potential pullback in lending to consumers and businesses at a time when economic growth is already being squeezed.

In the lightning-fast world of financial markets, the efforts by Mr. Sarkozy, Chancellor Angela Merkel of Germany and other euro zone leaders appear to be moving too slowly to satisfy the demands of investors.

While the summit meeting in Brussels on Thursday and Friday marked a major step toward greater fiscal union among the core countries, the architecture will take months, even years, to construct.

In the meantime, the decision to embrace significant new spending cuts and tax increases across much of Europe at a time of economic weakness is expected to undermine growth in the immediate future, analysts said.

ALVARO BARRIENTOS/THE ASSOCIATED PRESS

A couple at a cafe in Pamplona, Spain. Any further downgrade in the credit rating of European governments could make it more expensive for the weakest countries to service their debts and for banks in those countries to get credit from other lenders.

Carl B. Weinberg, the chief economist at High Frequency Economics, said some European banks that were already selling assets to keep enough money on hand were also curbing lending.

"We are now moving off the charts in terms of normal procedures, and moving into a grim time for European banks," Mr. Weinberg said. "This is not a good time to be thinking of European bank shares because a contraction of credit has already begun and will get worse."

Indeed, despite the political will to bring the euro zone under more centralized management, ratings agencies, banks and businesses are increasingly considering the possibility that countries could default, or leave the currency union.

Many governments and investors are hoping the E.C.B. will ride to the rescue by buying the bonds of troubled governments in Italy and Spain, in a bid to keep their borrowing costs from rising to levels that forced Greece, Ireland and Portugal to take international bailouts.

But Germany has opposed that move as being outside the bank's mandate, and the E.C.B. president, Mario Draghi, made clear last week that the bank remained loath to take such steps.

Keeping the heat on Italy, Spain and Portugal to limit their borrowing, the E.C.B. reduced its bond purchases of sovereign debt last week. The bank spent €635 million, or $850 million, buying bonds on the open market, down from €3.7 billion the previous week, according to data disclosed Monday.

The total since the E.C.B. began buying government bonds last year stood at €207.5 billion, about a tenth of what the Federal Reserve has spent as part of its effort to bolster growth in the United States by adding to the money supply.

Bond trading is typically thin in December, so the E.C.B. had less need to intervene.

Jens Weidmann, the president of the Bundesbank, praised what he said was progress made at the summit meeting. But, in an interview with the Frankfurter Allgemeine, he showed no sign of softening Germany's stance that bond buying to prop up indebted countries was illegal.

Moody's, in its assessment Monday, said the crisis was "in a critical and volatile stage." It warned that the longer policy makers took an incremental approach to the crisis, "the greater the likelihood of more severe scenarios, including those involving multiple defaults by euro area countries and those additionally involving exits from the euro area."

In Brussels, one legal problem arose Monday with the planned new intergovernmental treaty — or fiscal compact for the euro zone — which most E.U. members agreed to Friday.

The nations had promised to tighten the rules spelling out action against countries that exceeded budget deficit limits of 3 percent of gross domestic product. The idea was to make it harder for such nations to escape measures against them.

Though a political agreement can be made to do so, one change the countries want to make will not have legal force, said European officials who were not authorized to speak publicly. That is because the rules on this procedure would require a change to the E.U's governing treaty to have full force.

"We are now moving off the charts in terms of normal procedures, and moving into a grim time for European banks."

But Olli Rehn, European commissioner for economic and monetary affairs, said that most of the changes could be enforced.

"The results of this summit are better than first meets the eye," he said, adding that people "should not underestimate its potential to fundamentally change the landscape of fiscal and economic policy making in Europe."

Jack Ewing in Frankfurt and Stephen Castle in Brussels contributed reporting.