E.U. delays action on shoring up rescue fund

29/2/2012
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FRANKFURT

Decisions in Germany and Ireland underscore hurdles to united Europe

BY JACK EWING, STEPHEN CASTLE AND MELISSA EDDY

European political leaders on Tuesday postponed a crucial crisis meeting planned for this week after a series of new setbacks to the euro illustrated again how hard it was to reconcile impatient financial markets with democratic processes.

Ireland said it would hold a referendum on an agreement to impose fiscal discipline on members of the euro zone. The prospect of more political turmoil seemed to unsettle investors, even though the country's approval is not needed for the accord to take effect. Irish voters have a history of rejecting European Union measures at the polls; the euro dropped after the news before recovering.

In Germany, the constitutional court issued a ruling Tuesday that was likely to slow down parliamentary approval of emergency measures in response to the European debt crisis. The ruling came a day after members of Chancellor Angela Merkel's party rebelled against helping to pay for the latest plan to rescue Greece.

Domestic politics in euro zone countries have emerged again as a major obstacle to resolving the crisis, and contributed to a decision, not unexpected, by euro zone leaders to postpone a meeting they had planned for Friday. They were to discuss building a stronger financial firewall to prevent debt problems in one country from spreading to others.

The meeting had been expected to take place after a summit meeting of all 27 E.U. heads of government, which will still go ahead.

Darkening the outlook, an official report highlighted how much risk remained in the euro zone. Portugal faces a sharp contraction this year as austerity measures take their toll, the International Monetary Fund said in an assess-

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JOSÉ SENA GOULÃO/EPA

Vítor Gaspar, the finance minister of Portugal, where the economy is shrinking.

FRESH WORRIES OVER EURO ZONE DEBTS

The E.C.B. sought to calm markets after a ratings agency declared a "selective default" by Greece. *PAGE 15*

Euro zone leaders forced to postpone crisis talks

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ment of the country's progress in overcoming its debt and economic problems. The warning came a day after Spain said that its budget deficit last year was much larger than had been expected, highlighting how difficult it is for countries to simultaneously cut borrowing and restore economic growth.

The postponement of the Friday meeting because of the developments in Germany and Ireland means that a decision to increase the bailout fund is not now likely until later in March.

Leaders outside Europe including Timothy F. Geithner, the U.S. Treasury secretary, have urged euro zone leaders to increase the firewall by hundreds of billions of euros, to at least €1 trillion, or nearly $1.35 trillion. But officials in Berlin argue that expanding the size of the fund could send a negative signal to financial markets while Greece is involved in a complicated bond swap. They argue that the move would sap confidence by implying that large countries like Italy or Spain are also at risk.

Other European leaders believe that the euro zone should take advantage of improved sentiment after the European Central Bank last month vastly expanded its low-cost loans to banks, and following progress on a second Greek bailout. Increasing the firewall would restore confidence and help the euro zone emerge from an economic downturn, other leaders argue.

Still, the leaders decided it was not a good time to press Germany, said one official who was not authorized to speak publicly.

On Monday, the German Parliament approved its contribution to the latest Greek rescue package by an overwhelming majority, but 17 members of Mrs. Merkel's coalition government voted against the measure and three abstained. That was a rebuke to Mrs. Merkel. German political parties expect loyalty from their members of Parliament, and it is rare for them to vote against their own blocs.

Polls show that a large majority of Germans believe that attempts to save Greece are futile and a waste of their money — a view shared by many professional economists.

"How long will countries like Greece endure reform policies that are in many respects illusory?" the Frankfurter Allgemeine newspaper wrote in a front-page editorial Tuesday. "And how long will taxpayers in the donor countries be willing and able to finance such grand

FRANCISCO SECO/THE ASSOCIATED PRESS

A store in Lisbon. Like all of the troubled countries in the euro zone, Portugal is trying to restore economic growth at the same time that it sharply reduces government spending.

political-economic experiments?"

A euro zone official, speaking on condition of anonymity, said, "Germany doesn't seem ready yet to swallow that pill, so it just made no sense to have a meeting that would put pressure on them."

Irish voters would probably approve their country's participation in a euro zone fiscal discipline pact, approval that would be required were Ireland itself to need a second bailout. But the vote would be close, according to a poll cited by Reuters. Approval by at least 12 of the 17 countries in the euro zone would be needed for the pact to take effect.

Ireland rejected in 2008 the Lisbon Treaty, a measure to streamline the European Union's operations, but later approved it after changes were made. It was not certain when the new vote would be held, but probably not for several months.

The European Commission, the bloc's executive arm, has called for the resources of a temporary bailout fund to be combined with that of a new permanent fund. The permanent fund would have €500 billion. The temporary fund, the European Financial Stability Facility, or E.F.S.F., has around €250 billion, of which about €100 billion will probably be used to finance the latest bailout of Greece.

Finance ministers in the euro zone will meet Thursday to decide whether to go ahead with the bailout, which depends on Greece's carrying out additional spending cuts and measures designed to make the economy function better.

Christine Lagarde, president of the International Monetary Fund, said last week that the scale of the I.M.F. contribution to the next Greek rescue would depend upon Europe's willingness to increase the firewall.

Germany's highest court on Tuesday ruled that Germany must convene all 620 members of its Parliament to approve most emergency measures to be taken by the euro zone's rescue fund. The German constitutional court said that a nine-member committee set up to approve urgent action by the bailout fund was "in large part" unconstitutional. The panel could authorize only some government bond purchases by the bailout fund.

Leaders decided it was not a good time to press Germany.

Andreas Vosskuhle, the lead presiding judge, said in a televised announcement of the court's decision that it was based on the need to guarantee "as much parliamentary legitimization as possible."

The ruling Tuesday does not affect any existing German decisions on aid for struggling euro zone partners, but it does mean that future approval may take longer and become more difficult.

"It remains a 'technicality' but it demonstrates that the court remains a key hurdle with regard to the debt crisis," said Thomas Costerg, an economist at Standard Charted Bank. "There is a dilemma between the need for democratic accounting and the need for efficiency and speed: gathering the Parliament for each E.F.S.F. money disbursement is quite cumbersome."

In an update on Portugal's progress, a team from the I.M.F. as well as the European Commission and the European Central Bank praised progress that the country had made in cutting its deficit, strengthening its banks and deregulating the labor market. But they warned that the economy was likely to contract 3.25 percent this year after falling 1.5 percent in 2011. In a joint statement, they said that Portugal still needed to do more to remove impediments to growth, like dismantling quasi-cartels that raise prices for local services.

"Portugal is making good progress toward adjusting its economic imbalances," the I.M.F. and the other two institutions said in the statement. "Determined implementation of reforms remains key to ensure economic recovery and fiscal sustainability."

Like all of the troubled countries, Portugal is trying to restore economic growth at the same time that it sharply reduces government spending. On Monday, Spain reported that its budget deficit in 2011 was 8.5 percent of gross domestic product, much higher than had been expected, largely because regional governments did not meet their spending goals.

The European Commission indicated Tuesday that it was unlikely to relax financial targets for Spain despite news that the country was falling behind.

"We are not talking about giving flexibility," Olivier Bailly, a spokesman for the European Commission, said Tuesday, adding that member states needed to "maintain commitments."

In a bit of encouraging news, the European Commission's economic sentiment indicator, released Tuesday, rose in February to its highest level since October. The data suggested that an economic downturn that began in the euro zone at the end of 2011 could end soon. But there remains a large gap between northern Europe and troubled countries like Greece, Portugal and Italy.

The sentiment indicator "confirms our expectation that the economic divide between the euro zone countries will remain substantial in 2012," Christoph Weil, an economist at Commerzbank, wrote Tuesday in a note to clients.

Melissa Eddy reported from Berlin and Stephen Castle reported from Brussels. Raphael Minder contributed from Spain.

E.C.B. seeks to reassure markets on Greek debt

FRANKFURT

New S.&P. downgrade raises fears about latest euro zone bailout deal

BY JACK EWING
AND LANDON THOMAS JR.

The European Central Bank acted Tuesday to prevent a potential collapse of the Greek banking system, after the country was declared by Standard & Poor's to be in "selective default," making Greek bonds ineligible as collateral for E.C.B. loans.

Even as the central bank sought to calm jitters, concern has increased that Europe's plan for an orderly debt restructuring might be at risk.

The International Swaps and Derivatives Association, the global body that oversees the market for credit-default swaps, said it would decide Wednesday whether the enactment in Greece of a law that could require private bondholders to take a loss on their holdings constituted what the industry calls a credit event. A positive ruling should lead to insurancelike payments to investors holding credit-default swaps — which while largely expected, could generate yet another wave of concern about the health of European banks.

S.&P. issued its downgrade late Monday because of the debt-reduction deal reached last week in which Greece will pay back less than half the face value of its bonds held by private creditors. The agreement is ostensibly voluntary.

The E.C.B. did not specifically mention the S.&P. downgrade Tuesday, but said in a statement that the agreement with creditors meant that Greek bonds could no longer be used as collateral to get cash from the central bank.

But the E.C.B. said banks could continue to draw cash from national central banks temporarily under a separate program known as emergency liquidity assistance. The E.C.B. said it would accept Greek bonds as collateral again in mid-March, when European governments will guarantee part of the value of Greek bonds under a new program.

In Athens, the Greek Finance Ministry said that "the downgrade has no impact in the Greek banking sector" because the Bank of Greece and the European bailout fund would step into the breach.

Since the beginning of the financial crisis in 2008, the E.C.B. has been allowing banks in the euro zone to borrow as much money as they want at the benchmark interest rate, which currently is 1 percent. But banks must post collateral. They typically have large holdings of their own country's debt, which they use as collateral. That makes them highly vulnerable if the debt is declared to be in default.

Greek banks would probably collapse if they could not use their holdings of domestic bonds as collateral to obtain cash, and banks in some other countries might also run into problems.

Collateral is particularly important for euro zone banks this week. On Tuesday, the E.C.B. began an operation to provide banks with three-year loans at 1 percent interest, the second installment of recently introduced longer-term loans. On Wednesday the central bank will announce how much banks borrowed. Banks are to get the money Thursday.

Greek banks would probably fail if they could not use their holdings of domestic bonds as collateral to obtain cash.

An earlier round of three-year loans in December has been crucial in reducing financial tension in the euro zone.

As a further sign of that, Italy, which has also come under pressure because of its heavy debt load, sold €3.75 billion, or $5 billion, of a new 10-year bond on Tuesday. The yield was 5.5 percent, the lowest level since September, Bloomberg News reported.

Yet in the view of many investors, the imposition of so-called collective action clauses, as well as the exclusion of the E.C.B.'s Greek bondholdings from the restructuring process, are grounds for a credit event, or default, because they are punitive to the private-sector bondholders.

Nevertheless, while traders reported a continued interest by investors in foreign-law Greek bonds — securities that give the investor greater legal protection if they want to challenge the restructuring deal — the broad feeling in the market was that the Greek government stood a good chance of getting enough investors to participate in the transaction to close the deal.

If enough investors take part in the planned bond exchange, ratings agencies are expected to remove the "selective default" rating from Greece. They would then become eligible as collateral again, albeit at a steep discount.

Landon Thomas Jr. reported from London.