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Focus shifts in search for euro zone solutions

BERLIN

Renewed call for bonds backed by bloc puts Merkel on the defensive

BY NICHOLAS KULISH
AND PAUL GEITNER

The pressure for Germany to reverse its defiant course on mutually guaranteed euro bonds continued to grow ahead of a dinner meeting of European leaders on Wednesday. But German officials said here Tuesday that there was no way they would bend on collective debt — even if the new French president, as expected, makes it a dining-room topic.

Angela Merkel, the German chancellor, finds herself increasingly on the defensive over the question of the bonds, which she opposes as a near-term remedy for the region's financial woes. But proponents say that bonds jointly issued by the 17 members of the euro currency union are the best long-term solution to the crisis that has destabilized worldwide markets and threatened the future of the currency.

Ms. Merkel is expected to face a consolidating front led by France's new president, François Hollande, when she travels to Brussels on Wednesday for the informal meeting of European Union leaders. Whether or not Mr. Hollande wins the argument, he has managed to change the nature of the debate.

Where for months the regional focus was on spending cuts and paring budget deficits, the discussion has shifted completely to ways to bolster growth. Many economists and policy makers now say that the surest way to put an end to the crisis is for European states to move toward jointly issued debt, known as euro bonds.

Certainly the renewed sense of crisis escalated Tuesday, as the Organization for Economic Cooperation and Development cut its growth forecast for the euro zone and said Europe risked creating a self-sustaining cycle of decline that could have dire effects for the world economy.

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Greece to aid 4 biggest banks with cash infusion

ATHENS

€18 billion is intended to replenish reserves and counter flight of deposits

BY LIZ ALDERMAN AND JACK EWING

The Greek government will pump €18 billion into the country's four largest commercial banks this week to help them guard against losses from a worsening economy, bankers in Athens said Tuesday, a step that will improve the banks' ability to raise funds but still leave them unable to lend money normally.

The injection, which has been planned for some time, comes as Greek businesses and consumers continue to withdraw substantial amounts of money from their bank accounts amid uncertainty about the country's political and economic future. More than €23 billion, or about $29 billion, in deposits was pulled from Greek banks in the eight months ended in March and €700 million more has been withdrawn since an inconclusive parliamentary election on May 6 fueled speculation that the country might exit the euro zone.

The Greek government last week received €25 billion from the European Financial Stability Facility, a bailout fund set up by euro zone governments to increase the capital cushions of banks across the currency union. To the frustration of bankers here, the Greek authorities delayed releasing a portion of the money to local banks.

Alexander Manos, managing director of Piraeus Bank, said the country's four biggest banks would receive a share of the money by Friday. The lenders — Piraeus, Alpha Bank, National Bank of Greece and Eurobank EFG — are among the nation's most troubled.

The money will help replenish the banks' capital reserves, which have been devastated by losses on their holdings of Greek government bonds and by bad loans to Greek clients. Nearly 16 percent of loans made by Greek banks last year went bad, compared with 7.7 percent in 2009, said Michalis Massourakis, the chief economist at Alpha Bank, which, like the other big lenders, is based in Athens.

"The overall health of the Greek banking system is good in the sense that

Businesses and consumers continue to withdraw money.

they are now well capitalized," Mr. Massourakis said. "But things are not really well because there is a lack of business, and a substantial outflow of deposits."

That has created a vicious cycle in the Greek economy, which is now in its fifth straight year of recession. Because deposits are fleeing banks, there is less money to lend. Without bank financing, thousands of small and midsize businesses have gone bankrupt. And with fewer companies demanding loans, business at Greek banks has come nearly to a standstill.

The only way to get the economy back on its feet, economists and business owners say, is for the banks to get healthy and start lending again.

The money coming to the Greek banks this week will allow them to regain access to normal funding from the European Central Bank, which has been serving as lender of last resort to weak banks in the euro zone that are unable to raise money on capital markets. But while the European funds will improve the banks' ability to lend, Mr. Manos of Piraeus Bank said, "the demand for new loans is very low."

Strictly speaking, the switch from E.C.B. funding to support from the euro zone bailout fund was merely an accounting move. But to some, it was confirmation that some Greek banks were close to insolvency.

Last week, the E.C.B. confirmed that some Greek banks had been cut off from normal access to central bank funds and had been switched to a program known as Emergency Liquidity Assistance, designed to help banks that have run out of collateral that they can use to borrow from the E.C.B. The E.C.B. has not disclosed the current volume of its lending to Greek banks through the assistance program, but analysts at Barclays estimate the total reached €96 billion in May.

The E.C.B. said last week that it would begin lending on normal terms to the Greek banks once they received the euro zone recapitalization funds, which will eventually total €48 billion. That would at least remove the stigma of receiving emergency aid.

"It's a small first step," said a senior banker who did not wish to be identified because he did not want to alienate Greek officials. But he noted that Greece also lacks a permanent government — at least until new elections, scheduled for June 17 — and is behind on a program to restructure the dysfunctional economy.

"We need a government. We need to get the program back on track," the banker said. "We need all these things to be in place before banks can be in any position to play their traditional role."

Jack Ewing reported from Frankfurt.

Catching up with a frenzied euro zone

FRANKFURT

A primer on the issues facing governments, citizens and investors

BY JACK EWING

EMILIO MORENATTI/THE ASSOCIATED PRESS

A 54-year-old jobless man seeking help in Madrid. At nearly a quarter of the work force, unemployment in Spain is even worse than in Greece. Among young Spaniards, it tops 50 percent.

With the daily drumbeat of alarming news from the euro zone, it's often hard to hear above the din. Here's a quick chance to catch up before the shouting starts again.

Q. What's all this talk about "contagion?" Why is the global economy threatened by a small country like Greece, or a few troubled Spanish banks?

A. If Greece leaves the euro, anyone who is owed money by the Greek government or private individuals there can probably forget about getting paid in full. In fact, that has already happened to a lot of Greece's creditors in the debt restructuring completed in March.

The next time, if it comes, a lot of the people getting hurt would be European taxpayers, because most of the government debt is owned by the European Central Bank or the European Union. The investment bank UBS estimates the total cost at €225 billion, or $286.5 billion.

Commercial banks that have extended loans to Greek clients would also suffer. And some could fail, destabilizing the European financial system, which is already vulnerable enough. Likewise, the failure of several banks in Spain or elsewhere could stick those banks' creditors with losses, perhaps causing more failures, as the problems cascaded through the system.

But the biggest effect might be psychological. Investors would begin to worry that the whole common currency union would fall apart. Europe could become toxic to international lenders and investors. Governments and businesses in the region could be cut off from credit, with disastrous effects on the whole economy.

Q. What about the social and geopolitical effects if Greece leaves the euro?

A. The social effect of the crisis is already visible in jobless numbers, which are at depression levels in Spain and Greece, and at a record high of 10.9 percent for the euro zone as a whole.

There are also political consequences. In countries like Greece, the Netherlands or even France, the economic pain is nourishing the growth of parties on the far right and far left, as voters lose faith in mainstream political leaders.

At the geopolitical level, Europe has lost prestige because of the perception that its leaders have mishandled the crisis.

All these trends would intensify if Greece left the euro zone, raising questions whether the Continent could continue the historic economic and political integration that followed World War II. The whole concept of Europe as a single entity might be in doubt.

Q. Now Spain seems to be a big worry. Is Spain just another Greece — but one with an economy and population more than four times as large?

A. Spain is in better shape than Greece by many measures. But, yes, it's a much bigger country. So its problems could cause much more trouble.

Spanish government debt is equal to about 69 percent of gross domestic product. That is far more manageable than in Greece, where the ratio is 165 percent.

The gaping issue with Spain, though, is not public debt but private i.o.u.'s. A real estate boom and bust has left Spanish banks burdened with €663 billion in property loans. A bank bailout would cost an estimated €200 billion, which the government in Madrid could not finance without European help.

Economists estimate the cost of a Greek exit from the euro zone at as much as €500 billion. The cost of a Spanish collapse would be in the trillions.

Q. What are the main ways that Europe has tried to solve the debt crisis, and why aren't those remedies working?

A. European leaders have created a €780 billion bailout fund with a lending capacity of €500 billion. That would not be adequate to deal with a collapse in investor confidence in Spain or Italy.

Leaders from the United States and elsewhere have called on Europe to commit a wall of money so large that it would erase all doubts about leaders' commitment to the euro. Such a wall would probably have to be worth €2 trillion or more.

German leaders like Wolfgang Schäuble, the finance minister, have resisted committing more sums, however, because they fear South European countries would feel less pressure to fix the underlying weaknesses in their economies.

Q. We keep hearing about "growth versus austerity." Are the two mutually exclusive?

A. Economists practically get into fist fights on this issue. In Germany, the prevailing view is that growth is the natural outcome of budgetary prudence by the government. Austerity, the argument goes, will restore confidence of both consumers and investors and lead to growth.

On the other side, economists of a Keynesian bent say that countries should increase government spending to stimulate growth. But this may not be an option for Greece, Portugal and some other countries, because no one is willing to give them any more money.

There is a growing acknowledgement, even in Germany, that austerity may have been overdone. When a country's economy shrinks, so does tax revenue, and the debt becomes that much more overwhelming. Greece's economy is one-quarter smaller today than it was in 2008, while the debt has continued to increase.

One problem is that countries like Italy and Greece already have what are generally considered to be bloated government agencies that burden business with paperwork and regulations and impede job creation. So stimulus would help only if the government spent the money wisely. Policy makers are now arguing about ways to offer Greece some relief from austerity without reinforcing bad habits.

Q. Who's actually in charge of the currency union? Is it Angela Merkel, the chancellor of Germany? Or is Mario Draghi, the president of the European Central Bank, the de facto leader?

A. The euro zone has no strong political leader; the United States of Europe does not yet exist. As leader of the largest and strongest big economy in Europe, Ms. Merkel has been in a position to push policies on countries that are dependent on aid, creating much resentment on the streets of Athens.

Mr. Draghi is arguably more powerful, because the European Central Bank controls the currency printing presses and does not need legislative or popular approval to act.

But the E.C.B. controls only monetary policy. It sets official interest rates and provides loans to banks to make sure they have money they need to operate. The E.C.B. cannot rescue banks that have too many bad loans and are insolvent. Nor, by law, can it rescue governments by buying all their bonds. (It has bought some government bonds, but not on the same scale as the Federal Reserve has done in the United States.)

Because the euro zone has no real central government, policy making has consisted of continuous brinkmanship between those that have money — Germany and the E.C.B. — and those that don't. The haves demand policy overhauls in return for aid, while the have-nots, especially in Greece, try to get more aid by raising the threat of euro Armageddon. The spectacle has been deeply unsettling for financial markets.

Q. We hear about a "bank run" in Greece, and the specter of one in Spain. If every country in the euro zone uses the same currency, why aren't one country's banks as safe as any other's?

A. Talk of bank runs is probably overblown, at least so far. But it's true that Europe lacks the equivalent of the Federal Deposit Insurance Corp. in the United States. Individual countries have their own versions of the F.D.I.C., but depositors in Greece or Spain are understandably nervous about whether their governments would have the

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Europe shifts focus on crisis relief

EURO BONDS, FROM PAGE 1

And in Spain, teachers went on strike across the country, protesting €10 billion, or $12.7 billion, in educational spending cuts approved last week by a Parliament intent on meeting more stringent budget targets.

Euro bonds are proponents' increasingly favorite idea for addressing the region's economic plight. Although many details would need to be worked out, the idea would be to have the euro zone countries collectively issue bonds that would be jointly guaranteed by all of its 17 members. But the most creditworthy countries, like Germany, would be almost certain to see their borrowing costs as they, in essence, would guarantee the loans of their more debt-saddled neighbors.

And though Ms. Merkel may be finding herself increasingly talking the minority position, she is not alone. Others arguing against euro bonds include Austria, Finland and the Netherlands.

"Euro bonds appear to be a straightforward solution, an easy answer to a very difficult question," said Tanja A. Börzel, a professor of E.U. politics at the Free University in Berlin. "The real question is whether this is politically feasible and even legally feasible in Germany."

Conservative German state politicians from Ms. Merkel's bloc on Tuesday put out a statement rejecting euro bonds, calling them "the fatal path to debt union." When Germany's constitutional court signed off on the euro zone bailout fund last September, it also appeared to rule out taking on collective debt.

In her public comments on euro bonds, Ms. Merkel has not completely dismissed them as a potential long-term solution. But a senior German official who spoke in Berlin ahead of Ms. Merkel's trip to Brussels said that there was "no legal basis" for euro bonds and that they were "explicitly forbidden" by E.U. treaties. The official, who spoke on the condition of anonymity about the closed-door discussions, said Ms. Merkel's position on euro bonds had not changed and was not going to change.

"I do not see euro bonds as a subject for tomorrow evening," the official said Tuesday. "Our position is well known."

No major policy changes can happen without Ms. Merkel and Germany, Europe's largest economy and the last of the euro zone's largest countries to maintain a triple-A credit rating. Throughout the euro crisis Ms. Merkel has pursued a strategy of standing firm until the last possible minute before

No major policy changes can happen without Germany.

small, tactical retreats from her hardest-line positions. But euro bonds have been a red line for Ms. Merkel and her party.

Conservatives in Germany argue that allowing deeply indebted states to borrow more cheaply by piggybacking on Germany's top credit rating would also ease pressure on those countries to make long-term economic overhauls. Euro bonds, they say, might address the problem for a few years but eventually the overall indebtedness of the bloc would reach unsustainable levels and the smaller states would, the thinking goes, pull Germany under with them.

Many in Germany believe that much of the pressure on Ms. Merkel to change course is about politics more than economics. Mr. Hollande faces parliamentary elections next month and needs to show French voters that he is standing up to the German chancellor. President Barack Obama, who hosted leaders of the Group of 8 leading industrial nations last weekend at his Camp David retreat, wants Europe to contain its economic problems ahead of the November presidential election in the United States.

While it is popular to talk about euro bonds, getting them off the ground would be another matter entirely. Few believe that the Germans, or their allies in fiscal rectitude in Finland, Austria, the Netherlands and elsewhere, would endorse a blank-check form of debt issuance for the Greeks. Some kind of hybrid system, where only a portion of debt is jointly issued or where only states with total obligations below a certain percentage of gross domestic product can participate, is most likely.

And a new institution might have to be founded to manage debt auctions, either through the European Commission or by modifying the structures of the European bailout funds. And it is unclear how that money would be used to revive the Greek economy in the short run.

"Throwing money at them won't do the trick alone," said Ms. Börzel of the Free University. "They don't have the absorption capacity, neither the administration nor the economy."

The political stalemate in Greece after elections there has revived fears that the country could have to abandon the euro, causing shock waves that could have unpredictable reverberations throughout the global economy. While a discussion of Greece is planned at dinner, diplomats in Brussels on Tuesday said leaders' hands would be tied until a new government was chosen.

At the same time, new concerns about the solidity of Spanish banks — and whether Madrid has the wherewithal to stand behind them — have darkened the outlook considerably.

Paul Geitner reported from Brussels, where James Kanter contributed reporting. David Jolly contributed from Paris.