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Europe weighs up limited Spanish rescue

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By Peter Spiegel in Brussels, Victor Mallet in Madrid and Ralph Atkins in Frankfurt

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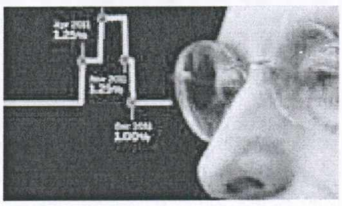
European officials are weighing up a bailout programme for Spain that would aid its fragile domestic banking sector while imposing only "very limited conditionality" on Madrid, a concession that could make a reluctant Spanish government more willing to accept international assistance.

Unlike earlier bailouts for Greece, Portugal and Ireland, the proposed Spanish rescue would require few austerity measures beyond reforms already agreed with the EU and could even dispense with the close monitoring by international lenders that has proved contentious in Athens and Dublin, according to people familiar with the plans.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EU support would instead be contingent on increased external oversight and accelerated restructuring of the Spanish financial sector to address lingering concerns about political interference and cronyism in the *cajas*, the regional savings banks that loaded up on questionable real estate loans during the housing bubble.

Mario Draghi, president of the European Central Bank, added to the pressure building on EU and Spanish officials on Wednesday, after he left interest rates unchanged and put the onus to solve the eurozone debt crisis squarely on the continent's politicians. While saying the ECB stood "ready to act", Mr Draghi insisted that most of the problems befalling the eurozone have "nothing to do with monetary policy".

The ECB did, however, signal that it might cut eurozone official interest rates next month given "increased downside risks" to the region's economy. With interest rates currently set at a historic low of 1 per cent, a July cut would take them below levels seen even in the depths of the 2009 recession.

On the other side of the Atlantic, the S&P rose 2.3 per cent, its best one-day gain this year, with investors hopeful that central banks will provide additional stimulus.

The yield on 10-year Treasuries rose 10 basis points to 1.66 per cent as risk assets, led by copper and oil surged. Gold prices rose 1.3 per cent to a one-month high of $1,637 an ounce, as investors priced in higher odds of quantitative easing from the Federal Reserve.

The ECB also said it would continue to provide unlimited three-month loans to eurozone banks through at least the end of the year. But Mr Draghi shunned calls for the ECB to take bolder action to resolve the eurozone crisis, for instance, by repeating its past offers of unlimited three year loans. "I don't think it would be right for monetary policy to fill [in for] other institutions' lack of action," he said.

European officials said they were willing to consider a less intrusive monitoring system for Spain because Mariano Rajoy, prime minister, introduced a series of reforms and austerity measures earlier this year. "There may be better means of recapitalising banks than through a full programme ... especially as the Spanish government is doing all the right things in structural terms," said one senior official involved in the talks.

The most significant remaining stumbling block, officials said, is Mr Rajoy's unwillingness to accept an aid programme after insisting for months it was not needed. Madrid is also worried about stigmatising all its banks.

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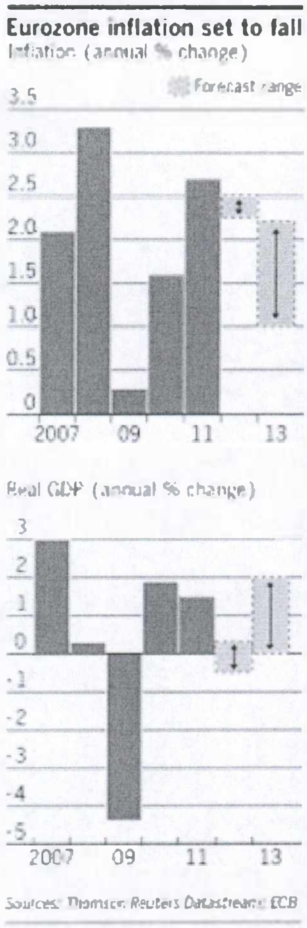
The centre-right government insists it will not take any decision on whether to ask for help – or how much to request – until after the International Monetary Fund and two consultancies, Oliver Wyman and Roland Berger , have concluded their investigations into the Spanish banking sector.

"Eurozone member states have an incentive to design a programme that would emphasize banks and be 'conditionality light' to facilitate Rajoy's ability to manage his domestic constraints," said Mujtaba Rahman, a Europe analyst at the Eurasia Group risk consultancy. "The longer the Spanish situation drags out, the greater is the risk that Italy will also come back into play."

EU officials are also debating the size of the loans needed. Senior Spanish banking executives have put the figure at about €40bn, but people briefed on the discussion says EU officials have been looking at plans that are at least double that.

Spanish officials and bank regulators are confident that the IMF will conclude that the recapitalisation needs of the country's banks – principally the former cajas that make up Bankia, Catalunya Caixa and NovaCaixaGalicia – will be more modest than many foreign analysts assume.

Despite lobbying by Brussels and Paris, officials said direct bailout loans to troubled banks – bypassing the Spanish government – have been



ruled out. Regulations for the current €440bn eurozone rescue fund and its permanent €500bn successor forbid such direct capital injections and changing the rules would take too long.

One option under consideration would be for the European Financial Stablility Facility to provide the bailout aid directly to Spain's bank rescue fund, known by its Spanish initials Frob.

One senior official said the idea has not yet been completely analysed, though it could be acceptable since the Frob is part of the Spanish administration. Another senior EU official said, however, that loans would probably still have to go through normal government accounts. "In a sense, the sovereign would function as a transfer account and political guarantor, while the Frob would do the concrete job," said the second official.

Hopes that European policymakers will act to soothe the continent's financial crisis caused investors to pull money out of haven assets such as UK gilts and German Bunds, sending yields higher, and helped European stock markets to their biggest one-day gain since late November.

However, Mr Draghi's reluctance to commit the ECB to more longer-term bank loans or direct buying of government debt kept up pressure on Spanish and Italian bonds. After initially falling, Madrid and Rome's benchmark borrowing costs ended the day almost unchanged.

Additional reporting by Ralph Atkins in Frankfurt

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