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E.C.B. under pressure to ride to the euro's rescue

FRANKFURT

Bank's officials chafe at having to step in while politicians weigh options

BY JACK EWING

The European Central Bank must decide Wednesday whether to stand on principle and insist that political leaders take their turn at dealing with the euro zone's banking and debt crisis, or bend to market forces and once again ride to the rescue.

Based on economic and market indicators, and a growing sense of public panic, the top E.C.B. officials could easily justify a policy move when they hold their regular monthly meeting on Wednesday. The bank could, for example, cut the benchmark interest rate to a record low. Or it could flood commercial banks with more low-interest loans, something which worked to calming effect when it provided such infusions a few months ago.

But members of the E.C.B. governing council, and the bank president, Mario Draghi, might also be concerned that if they are too generous with monetary policy, the region's political leaders might be tempted to shirk the hard work of creating a more durable euro zone.

Last week, in a rare public rebuke to the region's elected officials, Mr. Draghi outlined the steps he said were necessary to strengthen the euro currency union, including requiring member nations to take shared responsibility for bank bailouts. If he walks this tough talk, the E.C.B. might not take action until political leaders have made tangible progress in that direction.

To help leaders head down that path, the European Commission on Wednesday is expected to propose steps toward a so-called banking union — measures that would include requirements that nations set up funds to deal with failing banks, with the money possibly shared by countries, and give the national authorities greater scope to intervene in troubled banks.

''With the euro-area crisis deteriorating, there is a lot of pressure on the E.C.B. to act — but in our view it is unlikely to announce any specific new measure this Wednesday,'' Silvio Peruzzo, an analyst at Royal Bank of Scotland, wrote Monday in a note to clients. Mr. Peruzzo

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YVES HERMAN/REUTERS

...rio Draghi has walked a fine line since ...ng the helm of the E.C.B. in November.

GERMANY ONCE MORE ON DEFENSIVE

Pressure is growing in the euro zone for pumping rescue aid directly into banks, something Berlin opposes. *PAGE 14*

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Germany once more on defensive in euro zone

PARIS

Pressure put on Berlin to allow rescue aid to flow directly into banks

BY DAVID JOLLY
AND JAMES KANTER

European Union and French officials squared off against Germany on Monday over how best to help Spain's ailing banks, drawing lines in the debate over the latest challenge to the euro zone.

Olli Rehn, the European commissioner for economic and monetary affairs, and Pierre Moscovici, the French finance minister, offered cautious endorsement at a news conference in Brussels for the idea of letting Europe's bailout funds inject money directly into troubled banks. Doing so could allow a de facto rescue of the Spanish banking industry without requiring the Spanish government to hew to the budgetary strictures of a Greek-style bailout — something Madrid has indicated it wants to avoid.

But Germany has opposed the idea of tapping the new bailout fund, the €500 billion, or $624.5 billion, European Stability Mechanism, to inject money directly into any country's banks. The Bundesbank, the German central bank, argues that the bailout fund has no capacity or expertise to manage bank bailouts, which would probably include restructuring of crippled lenders.

German officials have made clear that they want any bailout money to flow through governments, with strict conditions, until there is a European bank supervisor with sufficient staff and legal authority in place.

Whether Germany is willing to give ground on that stance might become clearer after a meeting scheduled for Monday evening in Berlin between Chancellor Angela Merkel of Germany and José Manuel Barroso, president of the European Commission, to discuss ways out of the euro crisis.

Although Greece's agony has grabbed most of the headlines this year, the Spanish financial sector lately has been sapped by steadily growing flight of bank deposits by nervous customers seeking havens in other countries. The Spanish government lacks the €60 billion to €80 billion needed to support its banks, which have been hit by the collapse of a real estate bubble and economic recession.

Europe's inability to master the euro situation and numerous signs that growth may be stalling in the United States and China have raised alarm bells around the world. President Barack Obama sought last week to spur European leaders into action, and central bankers and finance ministers from the Group of 7 industrialized nations will hold a conference call Tuesday to discuss the crisis, Reuters quoted the Canadian finance minister, Jim Flaherty, as saying Monday.

As lines were drawn on bailouts, Portugal cut its growth forecast and announced its own bank revival plan.

Mariano Rajoy, the Spanish prime minister, called Saturday for centralized budget control and the creation of a banking union, with the power to regulate and bail out banks. Euro zone countries should "cede more sovereignty" to a central fiscal authority, Bloomberg News quoted Mr. Rajoy as saying.

But Jésus Castillo, an economist who covers Spain at the investment firm Natixis in Paris, said Mr. Rajoy's comment should be seen as "a political gesture." The Spanish government "doesn't want to put up with the kind of conditions a bailout would require," Mr. Castillo said. "It would reduce their room to maneuver too much."

Steffen Seibert, a spokesman for Ms. Merkel, said Monday that Spain should decide whether to seek an international bailout. "Everyone knows that Europe is ready," Mr. Seibert said at a news conference. "But the decision lies with the Spanish government alone."

Mr. Rehn acknowledged at the Brussels news conference that direct injections into the banks from the bailout fund were not specifically authorized by the treaty that set up the European Stability Mechanism, or E.S.M. "But we see that it is important to consider this alternative of direct bank recapitalization," he said, "as we are now moving on in the discussion of the possible ways and means to create a banking union."

The E.S.M. was devised as the successor to the European Financial Stability Facility, a temporary fund that has already been tapped to help Greece, Ireland and Portugal.

Mr. Moscovici said there was a realization that "there needs to be a direct recapitalization of banks by the E.S.M.," and that the French government was "favorable" toward creating a banking union.

The idea of a banking union to coordi-

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Will E.C.B. stand firm or deliver fresh aid?

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said the E.C.B. would wait until after a summit meeting of euro zone leaders planned for the end of the month.

It is a fine line that Mr. Draghi and his predecessor, Jean-Claude Trichet, have walked since the debt crisis began more than two years ago. Both have seemed to resent being pushed into the role of lead crisis fighter because elected officials leaders cannot agree, or because they hope central bank policy can be a substitute for tough economic measures that would cost votes in the short term.

Like Mr. Trichet, Mr. Draghi does not want to reward dithering or infighting by political leaders. At the same time, the E.C.B.'s ultimate priority is to preserve the euro zone; it cannot afford to stand so firm on principle that the currency union crumbles beneath it.

During past episodes of heightened stress, the E.C.B. has come to the rescue, as in December when it extended the maximum term of low-interest loans to banks to three years, up from one. But that move, which calmed tensions for several months, was implicitly a reward for political progress. Italy, with a new, technocratic president in place, had just stepped up efforts to improve its economy. And euro zone leaders had recently agreed on tough new rules to enforce prudent spending by governments.

If anything, the sense of panic and doubts about the euro zone's future are even higher now than they were last autumn. The common currency has been trading near a two-year low against the dollar, euro zone unemployment is at a record of 11 percent, and Spain is trying to figure out how to pay for a bailout of its troubled banks.

The heightened tension has led to speculation that the E.C.B. will have to act, perhaps by resuming its purchases of government bonds in the open market. Doing so might relieve pressure on the bonds of governments like Spain, whose interest rates have recently been spiking to potentially dangerous levels. But the central bank discouraged such hopes on Monday when it disclosed that it made no bond purchases last week, for the 12th week in a row.

But while the pressure on the euro zone appears to investors to be acute, E.C.B. policy makers may not be as alarmed. Not all market indicators are negative. For example, interest rates that banks pay to borrow money for short periods have plummeted, a result of those inexpensive three-year loans that the E.C.B. has dispensed since Mr. Draghi took office in November.

"There is a difference between what we would like the E.C.B. to do and what will actually happen on Wednesday," Jens Sondergaard, senior European economist at Nomura, wrote in a note to clients. "We are not sure conditions across the euro area have deteriorated sufficiently for the E.C.B. to take action."

Among analysts who follow the E.C.B., there is plenty of disagreement about what the bank's governing council will decide. Some, noting that Mr. Draghi has presided over two interest rate cuts, expect some kind of action on Wednesday.

Economists at Barclays, for example, forecast that the E.C.B. would announce more rounds of long-term loans to banks, in an attempt to contain a flight of deposits from troubled countries like Greece or Spain.

Political leaders could also provide cover for the bank to act by announcing new measures to knit the euro zone more closely together, as the European Commission plans to propose on Wednesday.

Like an earlier accord to harmonize national budgets, the new plans would represent another shift in Europe toward the kind of federal management that bailouts have already forced upon member countries, to shore up their struggling economies and defend the euro. The commission's proposal is also aimed at ensuring that any future bank collapses would be paid for by the banking industry and bondholders rather than taxpayers. The plan is expected to be in line with measures called for by Mr. Draghi.

But the proposed steps will be too late to help banks already in trouble, like Bankia of Spain. Those shaky institutions could end up needing to tap funds like the €500 billion European Stability Mechanism bailout pool already established by European Union, even if the means by which banks get that money is still a matter of debate. Germany, for one, has argued that the money should be routed through Spain's government, to hold it accountable for the results.

Whether or not the E.C.B. takes action this week, many professional central bank watchers expect it to cut the benchmark interest rate to 0.75 percent or even 0.50 percent within the next several months. The current rate of 1 percent is already a record low.

The E.C.B. could also do something less expected, for example, by pledging to provide unlimited low-interest loans to banks for several years. That would be analogous to the U.S. Federal Reserve's promise last year to keep interest rates near zero through mid-2013.

Or, Mr. Draghi could signal that the E.C.B. is leaning toward a rate cut next month, thereby reassuring markets but leaving himself some room to maneuver if conditions change.

While the situation in the euro zone appears bad now, it could get much worse. There remain serious questions about whether Greece will be able to remain in it. The European economy could also deteriorate further. While the euro zone is not growing, it is not officially in recession either; but it soon could be.

The E.C.B. may decide it needs to keep some firepower in reserve, to address even more serious circumstances and to keep the heat on political leaders.

For the rest of the world, however, fearful for the fate of the global economy, the way things work in Europe can be unnerving. "As with so many of the euro zone crises," Ian Bremmer, president of the Eurasia Group, a consulting firm, wrote in a note Monday about efforts to find a solution for Spain, it is "a longer, messier, more painful process than you'd like."

James Kanter contributed reporting from Brussels.

Germany pressed over aid for banks

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nate the oversight of European banks, and possibly create a euro zone-wide guarantee fund to insure deposits, is quickly gaining traction. Enthusiasm seems to be growing among European countries, in direct proportion to Ms. Merkel's hostility to a previously proposed solution, euro bonds issued jointly by all 17 euro members.

''There are propositions on the table,'' said Mr. Moscovici, adding that he hoped they would be part of discussion at a meeting of European Union heads of state and government at a June 28-29 summit meeting in Brussels.

But Marco Valli, the chief euro zone economist at the Italian bank UniCredit, said European officials were still not focusing clearly enough on solving the problems immediately at hand.

''There are two very urgent topics that needed to be addressed if the euro is going to be saved,'' he said. One is the creation of a pan-European bank deposit insurance program, but the other, more urgent one, he said, is the necessity of using the European Stability Mechanism for recapitalizing banks directly.

''Questions about a single regulator, supervisor or resolution authority is something for the medium or longer term,'' he said. ''It could take a couple of years.''

Officials spoke Monday as Portugal cut its growth forecast and announced its bank recapitalization plan after the international Monetary Fund voiced its approval for the country's financial restructuring. The Portuguese finance minister, Vítor Gaspar, said gross domestic product was expected to grow 0.2 percent next year, down from the 0.6 percent growth the government estimated in late April.

Mr. Gaspar also forecast that the country's debt would peak next year at 118.6 percent of gross domestic product, three percentage points worse than expected.

Portugal's economic restructuring ''remains on track amidst continued challenges,'' the I.M.F. said. ''The authorities are implementing the reform policies broadly as planned and external adjustment is proceeding faster than expected.''

Still, the fund warned that rising unemployment in Portugal ''has emerged as a pressing concern.''

Portugal last year sought €78 billion from the so-called troika — the European Union, the European Central bank, and the International Monetary Fund — after a loss of confidence in its public finances left it unable to gain access to the bond market. Of the bailout funds, €12 billion was earmarked to repair banks' tattered balance sheets.

Three banks — Millennium, Banco BPI and Caixa Geral de Depósitos — will draw a combined €6.7 billion to help them meet new capital requirements. The Finance Ministry said those banks would be ''among the best capitalized in Europe'' after the transactions were completed.