FINANCIAL TIMES

Last updated: June 27, 2012 7:54 pm

Merkel digs in heels over action on euro

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Senior European officials worked behind closed doors to agree short-term measures to help lower Spanish and Italian borrowing costs ahead of a high-stakes EU summit on Thursday, but Angela Merkel, the German chancellor, dug in her heels, dubbing such quick remedies as "eyewash and fake solutions".

Despite the public resistance, senior officials involved in the closed-door deliberations said the German government was becoming more amenable to quick action and they were hopeful an agreement could be reached at the two-day summit.

The most likely plan, officials said, was to use the eurozone's €440bn rescue fund to purchase Italian and Spanish bonds, but the officials cautioned that no deal had been reached last night. Such a programme would require new reform conditions for both countries, particularly if the fund purchased bonds directly at auction rather than on the open market.

Other ideas, including finding ways to funnel bailout funds to Spanish banks through special investment vehicles, were also being explored, as was removing seniority status for Spanish bailout loans, according to people familiar with the talks.

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Mariano Rajoy, the Spanish prime minister, once again urged the European Central Bank or the rescue fund to dip into the Spanish and Italian bond markets to lower borrowing costs, a move backed by his French and Italian counterparts but resisted by Ms Merkel. Borrowing costs on benchmark 10-year Spanish bonds rose to near euro-era highs again on Thursday, closing above 6.9 per cent.

"The most important thing today is being able to finance ourselves in the markets," Mr Rajoy said. "We can't finance ourselves at the prices we are paying for very long."

Speaking before the German parliament, Ms Merkel acknowledged the summit could prove confrontational, with her French, Spanish and Italian counterparts all urging her to change tack and support new intervention in sovereign bond markets and more direct help for Spanish banks.

"I expect a controversial discussion," she said. "Many eyes will be focused on Germany."

But she held firm to her conviction that the eurozone's next move should be to institute more central controls over European banks and national budges, long her prerequisite for considering any new measures that commit German taxpayers to shouldering the debts of other, weaker economies.

"What we need much more [than joint liability] are new rules of enforcement when budget rules are broken," she said. "I believe that eurobonds, or mutualised debt, are the wrong way to go."

Despite German resistance, French officials said François Hollande, French president, would continue to press Ms Merkel to back a list of measures to assuage market concerns.

Welcoming Ms Merkel to the Elysée palace for pre-summit talks, President Hollande said the two leaders were "conscious of the measures we must prepare on financial stability" as well as the need to "deepen economic and monetary and, tomorrow, political union". He added: "We need integration as much as is necessary and solidarity as much as is possible."

Among the measures being pushed by Paris were injecting cash directly into teetering Spanish banks and a common eurozone deposit insurance scheme.

"This is an agenda which is very important for us for the Spanish situation but also for the whole European financial system," said one French official, ahead of a meeting Wednesday night between Mr Hollande and Ms Merkel.

Olli Rehn, the EU's top economic official who attended a pre-summit gathering with a small group of eurozone finance ministers in Paris on Tuesday night, said it was "essential" that the summit produce "measures for short-term market stabilisation" and said officials were still working on such a package.

On a conference call on Wednesday, eurozone finance ministers discussed both the Spanish and Cypriot bailouts. In a statement, ministers suggested the bailout for Spanish banks could be more than the €62bn identified by a private audit of the financial system, saying they would likely insist on a "safety margin" on top.

Which direction? Items on the summit agenda

SHORT-TERM ISSUES

Direct recapitalisation of banks
Aim: Using the eurozone's rescue fund, the ESM, to recapitalise Spanish banks, thus breaking the 'sovereign banking' loop
Impact: Would mean a bailout for Spain's banks worth up to €100bn would not count against government debt but would require a change
to ESM rules

Banking licence for ESM
Aim: Would give the eurozone rescue fund access to European Central Bank funding, greatly increasing its firepower
Impact: Pushed by France, it would remove worries about limited funds to fight contagion. Opposed by ECB and Germany