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Germany and Italy at odds on strategy

BERLIN

2 nations' leaders meet but are divided on how to bolster weak states

BY MELISSA EDDY
AND JACK EWING

Angela Merkel, the German chancellor, on Wednesday praised the progress that Italy's prime minister, Mario Monti, has made in revamping his country's economy. But she also indicated there were limits to how much financial risk Germany was willing to bear in helping out its euro zone allies.

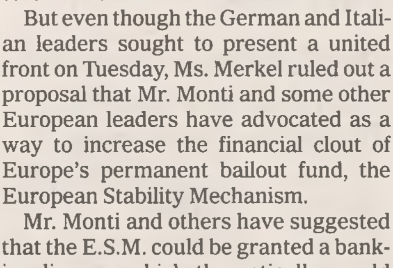
After a two-hour meeting with Mr. Monti in Berlin, Ms. Merkel said she was impressed by what she called the Italian government's "wide reaching" efforts to streamline the economy and cut government spending.

"I am personally convinced that these reform efforts will bear fruit, that they will improve Europe's overall competitiveness," she said.

Ms. Merkel has sought in recent weeks to shift the crisis narrative away from the financial burden being borne by German taxpayers, who remain leery of putting up more of their money for the sake of the euro. Instead, as the crisis begins to drag on German growth, Ms. Merkel has been emphasizing the sacrifices that troubled countries like Italy and Greece have made, and emphasizing how Germany's economic interests are intertwined with theirs.

But even though the German and Italian leaders sought to present a united front on Tuesday, Ms. Merkel ruled out a proposal that Mr. Monti and some other European leaders have advocated as a way to increase the financial clout of Europe's permanent bailout fund, the European Stability Mechanism.

Mr. Monti and others have suggested that the E.S.M. could be granted a banking license, which theoretically would allow it to draw low-interest loans from the European Central Bank. The E.S.M. could even issue bonds, and then post them as collateral for E.C.B. loans — in effect printing money. The appeal of that approach is that it would give the E.S.M. much more firepower, without direct commitments from E.U. member nations and the laborious approval process that has been required for each increase in the fund's size.



JULIEN WARNAND/EPA

Mr. Draghi, the E.C.B. chief, backs steps that may put more German funding at risk.

But Ms. Merkel said she agreed with Mario Draghi, the president of the E.C.B., that the rescue fund would not be eligible for central bank loans even if it had a banking license. She referred to a statement by Mr. Draghi this month that "the current design of the E.S.M. does not allow it to be recognized as a suitable counterparty."

Mr. Monti was undeterred. He praised Germany for taking a leadership role in the crisis and showing that each step takes time. But he left the door open for further discussion on the banking license issue, indicating that such a step-by-step approach could also be applied to the bailout funds.

"All of these issues must be viewed as a mosaic," Mr. Monti said after a two-hour meeting with Merkel. "All of these, the E.S.M., a banking license, are individual mosaic tiles that make up a complete picture."

Both leaders, who were meeting as part of round-robin European talks being held in recent weeks, face the two-pronged challenge of having to appeal to their own domestic audiences, weary of the crisis, while also trying to win back trust from markets more eager to see immediate results than long-term structural solutions.

Mr. Monti is also is also battling to drive down the debt of Italy, the euro zone's third-largest economy, after those of Germany and France, and spur growth through efforts that earned praise from the chancellor on Wednesday. Both leaders pointed to a government bond auction in Italy on Tuesday that raised €9 billion at rates considerably lower than a month ago.

"Markets are in the process of recognizing the successes," Mr. Monti said.

Meanwhile, Mr. Draghi, the E.C.B. chief, tried Wednesday to win German support, or at least acquiescence, for measures that are likely to put more German tax money at risk. In an article published by the weekly newsmagazine Die Zeit, Mr. Draghi wrote that the crisis might require the E.C.B. to "go beyond standard monetary policy tools." This was an apparent reference to proposals that the central bank buy government bonds to bring down borrowing costs for countries including Spain and Italy.

Special measures may be needed "when markets are fragmented or influenced by irrational fears."

The E.C.B. is expected next week to announce details on how it will try to intervene in the bond market. But the plan has met vehement resistance from Jens Weidmann, the president of the German central bank, the Bundesbank. Mr. Weidmann and other critics have complained that E.C.B. bond buying could shift risk in weaker countries to taxpayers in healthier countries like Germany or Finland, who could end up having to reimburse the central bank for any losses.

In what amounted to an appeal to the German people, Mr. Draghi said that special measures might be needed "when markets are fragmented or influenced by irrational fears," or when "monetary policy signals do not reach citizens evenly across the euro area."

The E.C.B. has expressed concern that measures it has taken so far, including record-low official interest rates and more than €1 trillion in low-interest loans to banks, have failed to filter down to businesses and consumers who need credit. Data published Tuesday by the E.C.B. showed that loans to businesses and households declined steeply in July in the countries most in need of economic growth, including Greece, Spain, Portugal and Ireland.

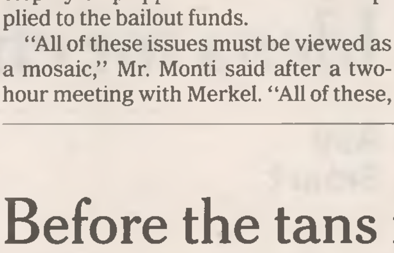
"We have to fix such blockages to ensure a single monetary policy and therefore price stability for all euro area citizens," Mr. Draghi wrote in Die Zeit. "This may at times require exceptional measures. But this is our responsibility as the central bank of the euro area as a whole."

He also implicitly responded to critics at the Bundesbank and in the German Parliament who have said that European countries cannot share financial risk until they create a full political union, with centralized control over national government spending.

"Those who claim only a full federation can be sustainable set the bar too high," he wrote. "What we need is a gradual and structured effort to complete" the European monetary union.

Jack Ewing reported from Frankfurt.

Before the tans fade, a primer on what to expect in Europe



Adam Davidson

IT'S THE ECONOMY

In June, it seemed as if any day might bring about the collapse of the Greek economy and with it, the entire euro zone and its decade-old currency. Then in July and August, it seemed as if everyone was on vacation. Now they're back — finance officials and political leaders have been flying all over Europe to meet with one another — and along with them the crisis that has been raging for the past two years. Here is a guide to the new season's most intriguing (and terrifying) story lines.

WHAT'S THE FIRST BIG MATCHUP? This month, Greece's Parliament needs to approve an additional €11.5 billion, or $14.4 billion, in spending cuts for 2013-14. If it does, it will most likely prompt big protests in the streets. If it doesn't, the European Commission, the International Monetary Fund and the European Central Bank, known as the troika, won't lend Greece the money to keep its economy afloat. If all sides get through September intact, they will still be at loggerheads during the next phase of budget negotiations.

WILL FRANCE'S 1 PERCENT PICK UP AND LEAVE? President François Hollande was elected, in part, for criticizing the austerity measures of his predecessor, Nicolas Sarkozy. Now Mr. Hollande is expected to cut more than €30 billion from his 2013 budget. So what's a poor Socialist to do? Go after the rich! Mr. Hollande has promised to increase the tax rate to 75 percent on incomes above €1 million, and has imposed a one-time wealth tax on people

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