EU Bailout Fault Lines Exposed in Slovakia

By LEOS ROUSEK, GORDON FAIRCLOUGH and MARCUS WALKER

BRATISLAVA, Slovakia—Slovak lawmakers held up the expansion of the euro zone’s bailout fund after the 16 other members ratified the changes, throwing up a new roadblock to the Continent’s efforts to tame its debt crisis.

The development highlights the fragility of proposed solutions to Europe’s debt crisis, as well as political tensions among European leaders and voters. Politicians were working on a deal to pass the legislation as early as this week.

The deadlock in Slovakia complicates European leaders' aim of reaching a breakthrough deal at their Oct. 23 summit on a package of measures to tackle the crisis—a package expected to cover the recapitalization of European banks, a push to resolve Greece’s debt crisis, and new proposals to maximize the bailout fund’s impact.

Slovak lawmakers said the parliament was likely eventually to approve the expansion of the European Financial Stability Facility, because most parties in parliament support the measure. But Slovakia first must deal with its own political turmoil: Its government also lost a vote of confidence late Tuesday.

Amid rising fears of a financial crash and recession, euro-zone governments are under pressure to deal quickly with challenges that include restructuring Greece’s debt, shoring up banks, and convincing financial markets that the bailout fund has enough firepower. As the drama in Slovakia showed, governments must also assuage voters and lawmakers in several countries where antibailout feeling is high.

Much rests on Europe’s ability to put together its promised package of crisis measures later this month. Many investors and policy makers in Europe and around the world say that without decisive action, the crisis could spiral out of control, threatening a meltdown of swaths of the euro zone’s banking sector and government-bond markets and undermining global growth.

Germany, France and other nations are working on a new approach to Greece’s crushing debts, to modify or even replace a bailout program for Athens agreed on in July. Since then, Greece has slipped further behind its budget targets, meaning it will need more money than expected. Many euro-zone governments are losing patience with Greece’s failure to overhaul its economy and fearful of a voter backlash if they lend more taxpayer money to Athens.

That is leading to negotiations about a Greek debt restructuring that could involve steep losses for bondholders, which include many European banks already struggling with heavy exposure to indebted southern members of the euro zone. To repair market confidence in European banks, German Chancellor Angela Merkel and French President Nicolas Sarkozy have promised to present a plan for bank recapitalization later this month.

Luxembourg’s Prime Minister Jean-Claude Juncker, who heads meetings of euro-zone finance ministers, told Austrian television Monday that Greece’s bondholders could face a “brutal haircut,” or reduction in their repayments, but that European authorities “need to ensure that this doesn’t lead to contagion elsewhere in the euro zone.”

The euro zone’s next steps rely on all 17 members first ratifying an earlier deal to boost the EFSF’s lending capacity to €440 billion ($600 billion) from around €250 billion currently. Governments want the extra firepower partly to shore up banks and bond markets against the turmoil that could follow a potential Greek default.

But even an expanded rescue fund faces growing demands on finite resources. The fund, created last year to rescue cash-strapped governments, is supposed to play a role in recapitalizing banks while also taking over the role of intervening in euro-zone bond markets from the European Central Bank. Euro-zone officials are working on ideas to maximize the impact of the EFSF’s resources in bond markets. One idea is for the fund to offer investors partial insurance against losses on the bonds of Italy and other countries under market pressure.

Many analysts are skeptical about the fund’s ability to perform all these roles effectively. Economists say the ECB will probably have to continue buying Italian and Spanish bonds to keep their borrowing costs down, even though the ECB wants to hand that job over to the bailout fund.

The fund’s expansion relies on guarantees from taxpayers across the euro zone. That is proving a hard sell in Slovakia, where some lawmakers
and voters argue that it's unfair to ask the small, relatively poor nation to bail out richer countries such as Greece that have borrowed and spent beyond their means.

"The EFSF is the biggest swindle against Slovak and European taxpayers," said Richard Sulik, head of the Freedom and Solidarity party and speaker of Slovakia's parliament.

Slovakia's Prime Minister Iveta Radicova

The government's inability to muster a majority stemmed from a rebellion against euro-zone bailouts by a junior member of the ruling center-right coalition, the Freedom and Solidarity party. The party argues that the bailout program for Greece is failing and that European taxpayers shouldn't be forced to throw good money after bad. A government shuffle is expected before a renewed vote on the EFSF.

In Finland, Germany and the Netherlands, some voters and lawmakers have vociferously opposed rescue loans for Greece, whose huge budget deficits and bloated government apparatus have landed it in a debt crisis that threatens to destabilize the global financial system.

Sympathy for Greece is in short supply among some Slovaks, for whom Greece is a richer country that failed to get its house in order. But many Slovaks also want to show support for a European project that also represents the country's hopes of prosperity and security.

An opinion poll published on Monday showed that 36% of Slovaks agree with Mr. Sulik's anti-bailout stance, while 45% of voters believe parliament should approve the expanded rescue fund.

Slovak Prime Minister Iveta Radicova pleaded with parliament to back the rescue-fund legislation, saying Slovakia risked isolating itself in Europe and triggering greater instability in global markets.

"Our euro is under threat," Ms. Radicova told lawmakers Tuesday. "The changing situation needs a quick and immediate reaction."

The holdouts were unmoved, arguing that Slovaks, who suffered deep budget cuts to qualify for euro membership in 2009, shouldn't subsidize more affluent Greeks. "It would be an honest solution to let Greece go bankrupt," Mr. Sulik said.

Although the opposition Social Democrats support the EFSF's expansion, they abstained in Tuesday's vote in an effort to bring down the center-right government.

Write to Leos Rousek at leos.rousek@dowjones.com, Gordon Fairclough at gordon.fairclough@wsj.com and Marcus Walker at marcus.walker@wsj.com