Europe Struggles for Crisis Cure Ahead of Summit

By James G. Neuger - Oct 26, 2011

European leaders “have risen to the challenge,” German Chancellor Angela Merkel said. French President Nicolas Sarkozy proclaimed their July 21 summit a “historic turning point” and Luxembourg Prime Minister Jean-Claude Juncker called it the “final package, of course,” to extinguish the debt inferno.

Then they went on vacation. Before they returned to work, the deal fizzled.

The euro’s stewards are back in Brussels today for an emergency summit struggling to heed the world’s calls to once and for all eradicate what U.S. Treasury Secretary Timothy F. Geithner called the “catastrophic risk” of the debt crisis. A potential Greek default threatens shockwaves that could engulf Italy and France, jolt the banking system and spell havoc for the global economy.

“Buck up, this crisis is going to be with us still for a while,” Barry Eichengreen, an economics professor at the University of California at Berkeley, said on “Bloomberg Surveillance” with Tom Keene and Ken Prewitt. “I fear they’re not going to take the kind of steps to resolve it.”

The benchmark Stoxx Europe 600 Index rose 1 percent to 242.65 at 2:21 p.m. in London after declining 0.7 percent yesterday. The measure has tumbled 17 percent from this year’s peak on Feb. 17. The MSCI Asia Pacific Index was unchanged today, while Standard & Poor’s 500 Index futures advanced 1 percent.

Days of Haggling

The gathering marks the interim climax to six days of haggling among finance ministers, central and commercial bankers, chancellors, presidents and prime ministers over the shape of Greece’s second bailout, the recapitalization of banks and the retooling of the 440 billion-euro ($612 billion) rescue fund into a more potent weapon.

The 14th crisis summit in 21 months starts with a meeting of all 27 European Union leaders at 6 p.m. The real business gets under way at 7:15 p.m. when chiefs of the 10 non-euro nations depart, leaving the rest to hash out a strategy that they already say requires more work.

The cancellation of a finance ministers’ meeting to precede the summit underscored the holes in the plan. The finance chiefs will now meet at an as-yet undetermined time after the summit to complete its main elements, including safeguarding banks and writing down Greek debt, according to an EU official.

Global exasperation with Europe’s response is deepening, with politicians from Australia to North America prodding the euro area to get ahead of the crisis before it infects the world economy. A Group of 20 meeting in Cannes, France, on Nov. 3-4 is Europe’s self-imposed deadline.

‘Europe Must Deliver’

Europe must “deliver on the commitments they’ve made,” Geithner said yesterday in Wilmington, North Carolina. “They’re saying a lot of the right things and they’re clearly working on it and they’re moving with a greater sense of urgency. That’s all welcome, but until we see what they come together with, it’s a little hard to
evaluate.”

Before arriving in Brussels, some leaders had unfinished business at home. Merkel, the biggest contributor to Europe’s bailouts, won parliamentary approval for her anti-crisis strategy, while Italian Prime Minister Silvio Berlusconi was straining for more budget cuts.

Greece, recipient of 110 billion euros as the first crisis victim last year, is counting on bond investors to accept “voluntary” losses as high as 60 percent and on euro governments and the International Monetary Fund to lend at least 109 billion euros more to enable it to pay its bills.

Writedowns Up to 60%

“We’re currently debating 50 percent to 60 percent in Europe,” Luxembourg’s Juncker said in an interview in Zurich yesterday. “We’ll have parallel talks in Brussels with banks and we’ll need to see what’s the result of a voluntary participation.”

 Strikes, tear gas and 120,000 tons of uncollected garbage on the streets of Athens accompanied the Greek parliament’s approval of more austerity measures, as Greek citizens’ tolerance of EU-mandated budget cuts was stretched to the breaking point.

Greece’s bond writedowns will determine the amount of damage to European banks, which need around 100 billion euros of extra capital, the EU estimated last week.

EU leaders will set a deadline of June 30, 2012, for banks to hold core capital reserves of 9 percent after writing down their holdings of sovereign debt, according to a draft statement prepared for today’s summit. The reserves must be of the “highest quality,” according to the document obtained by Bloomberg News.

Payment ‘Constraints’

Lenders are expected first to tap private sources to make up any capital shortfall and “should be subject to constraints regarding the distribution of dividends and bonus payments until the target has been attained.” The document doesn’t give an estimate of the total capital EU banks must raise to comply with the rule.

What started in Greece and spread to Ireland and Portugal now stalks Italy, the third-biggest euro economy. European officials expect Berlusconi to show up in Brussels with specifics on containing pension spending and a timeline for meeting deficit-reduction targets.

Berlusconi has yet to complete an austerity package whipped together on an August weekend that led the European Central Bank to start buying Italian bonds. The gains from that support have evaporated. Ten-year Italian notes yield 389 basis points more than benchmark German bunds, the same as on Aug. 4.

The EU said today it has yet to receive a letter drafted the Italian authorities outlining plans for measures to boost economic growth.

Controversial Policy

The Frankfurt-based central bank has bought 169.5 billion euros in bonds so far, starting with Greece, Ireland and Portugal last year, then extending the coverage to Italy and Spain. The increasingly controversial policy contributed to decisions by both Germans on its council to quit this year.

Euro-area leaders are debating how to obtain an ECB commitment to maintain the purchases without
appearing to give orders to the politically independent central bank, three people familiar with the deliberations said.

ECB involvement is crucial because mechanisms to scale up the government-financed rescue fund -- the European Financial Stability Facility -- won't be ready immediately after the summit and may not deliver enough, the people said.

Merkel used a speech in the lower house of parliament in Berlin today to invoke Germany’s “historic obligation” to defend the euro and Europe, saying the financial risk inherent in leveraging the euro-area rescue fund is “acceptable” and that bondholders must give Greece a bigger break to relieve its debt load.

**More Talks Needed**

Talks on boosting the EFSF’s 440 billion-euro war chest have centered on two models -- using it to insure bond sales and to fund a special investment vehicle that would court outside money, including from the IMF. Discussions of the second option only began this week, the people said. Its effectiveness would hinge on negotiations with credit-rating companies and international investors, they said.

Debate is continuing over how to pair a planned 500 billion-euro permanent fund with the current pool, which is scheduled to be wound down even though its loans for Greece’s second bailout package will run for up to 30 years.

**Transitional Cap**

Leaders will consider amending or scrapping a clause in the statutes of the permanent fund, the European Stability Mechanism, that caps lending during the transition phase between the two funds at 500 billion euros. One proposal is to leave the EFSF’s commitments -- 150 billion euros and counting -- untouched by the cap.

In case the EFSF is fully spent once the ESM takes over, getting rid of the limit would give Europe twin funds with combined clout of 940 billion euros. Also up for debate is whether to tone down the ESM’s provisions for bondholder burden-sharing, the people said.

“Europe is finally moving in the right direction but there is a sense that the remedies will fall short of the shock and awe response that is required to stabilize market expectations,” Domenico Lombardi, a former IMF official now at the Brookings Institution in Washington, said yesterday on Bloomberg Television.

To contact the reporter on this story: James G. Neuger in Brussels at jneuger@bloomberg.net

To contact the editor responsible for this story: James Hertling at jhertling@bloomberg.net

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