Leaders Piece Together an Effort to Keep the Euro Intact

By STEVEN ERLANGER

PARIS — European leaders are working overtime on a tentative deal to try to save the euro, which they hope to complete at a crucial summit meeting in Brussels this week. But rather than one transformative leap, the deal will have several moving parts, together meant to show resolve to protect Italy and Spain, revise the economic governance of the euro zone and prevent further debt crises, officials involved in the talks say.

Important disagreements persist, and the two primary leaders of the euro zone, Chancellor Angela Merkel of Germany and President Nicolas Sarkozy of France, will meet on Monday in Paris to try to hammer out a joint proposal for the summit meeting. That gathering begins on Thursday evening, and is considered a last chance this year to set the euro right, even as some investors and analysts are beginning to predict its collapse.

“The survival of the euro zone is in play,” one senior European official said. “So far it’s been too little, too late.”

The emerging solution is being negotiated under great pressure from the markets, the banks, the voters and the Obama administration, which wants an end to the uncertainty about the euro that is dragging down the global economy.

In the process, European leaders will begin to change the fundamental structure of the union, creating a form of centralized oversight of national budgets, with sanctions for the profligate, to reassure investors that this kind of sovereign-debt crisis is finally being managed and should not happen again.

The immediate focus of worry is on Italy and Spain, which have been buffeted by market speculation even as they move to fix their economies. That process took an important step on Sunday, as Italy’s cabinet agreed to a package of austerity measures to put the country in line for aid that would improve its financial stability.

The new euro package, as European and American officials describe it, is being negotiated along four main lines. It combines new promises of fiscal discipline that will be embedded in amendments to European treaties; a leveraging of the current bailout fund, the European Financial Stability Facility, to perhaps two or even three times its current balance; a tranche of money from the International Monetary Fund to augment the bailout fund; and quiet political cover for the European Central Bank to keep buying Italian and Spanish bonds aggressively in the interim, to ensure that those two countries — the third- and fourth-largest economies in the euro zone — are not driven into default by ruinous interest rates on their debt.

After consecutive, expensive failures to stabilize the markets and protect the euro, the broad plan emerging this week may have a better chance at succeeding, analysts say, in part because it weaves together measures that deal with the various issues of the euro, particularly the provision of a central authority that can monitor and override national budget decisions if they break the rules.
Still, even if all the parts are agreed upon in the meetings, which are bound to be fraught, the fundamental imbalances in the euro zone between north and south and between surplus countries and debtor ones will not go away. The euro will still be a single currency for 17 disparate nations in the European Union.

One dividing line is that the Germans, along with the Dutch and the Finns, remain adamantly opposed to what some consider the simplest solution: allowing the European Central Bank to become the euro zone’s lender of last resort and to buy sovereign bonds on the primary market, in unlimited amounts. Mrs. Merkel is also dead-set for now against collective debt instruments, like “eurobonds,” that would put taxpayers, particularly German ones, on the hook for the debt of others, which her government regards as illegal.

So Mr. Sarkozy and other European leaders are working on a less elegant and more phased way to create a pool of bailout money that is large enough to convince the markets there is little chance of a default on Italian and Spanish bonds, which should drive down rates to sustainable levels, European and American officials say.

Mrs. Merkel says it is time to get the euro’s fundamentals right. She is insisting on treaty changes to promote more fiscal discipline, including a limit on budget deficits, with outside supervision and surveillance of national budgets before they become dangerous, and clear sanctions for countries that fail to adhere to the firmer rules. Berlin wants the new standards backed up by the European Court of Justice or perhaps the European Commission, with the power to reject budgets that break the rules and return them for revision.

She would like the treaty changes to be accepted by all 27 members of the European Union, but failing that, she said she would accept treaty changes within the euro zone, with other countries who want to join in the future, like Poland, free to commit to the tougher rules now. Many countries, and not only Britain, are opposed to institutionalizing a two- or even three-tier European Union, fearing that their interests will be sacrificed and their voices diminished.

Mr. Sarkozy, as the political inheritor of Gaullism, disagrees about the reach and nature of European supervision of national budgets and about the role of European institutions in overseeing the fiscal affairs of sovereign states. The French are more jealous of their sovereignty and more skeptical of European courts, not wishing to give them — let alone the bureaucratic European Commission — more sway over national budgets and policies.

“Europe must be refounded and rethought,” Mr. Sarkozy said last week. “But the reform of Europe is not a march toward supranationality.”

In addition to fiscal discipline, France wants to emphasize the need to promote economic growth, because it does not believe that austerity alone will do more than throw the euro zone into recession, increasing debt, not reducing it.

Germany’s finance minister, Wolfgang Schäuble, believes that treaty changes can happen rapidly, without the need for a constitutional convention or referendums in some countries. Others are not so sure, given that any ceding of sovereignty is a major step that may require more than just a quick vote in national parliaments. Still, momentum toward binding new fiscal rules could be achieved by an intergovernmental agreement in the interim, while treaty changes go on apace.

That, in itself, could help stabilize the euro. If there is clear evidence of fiscal reforms now and tighter discipline for the future, some board members of the European Central Bank and its new head, Mario
Draghi, have strongly hinted that the bank would move more aggressively to protect Italy and Spain.

At the same time, the bailout fund, which Europeans once hoped could be leveraged from its current $590 billion to more than $1.35 trillion, needs strengthening in light of the higher interest rates even AAA-rated countries like France are now having to pay.

After the bailouts for Greece, Ireland and Portugal, the fund has only about $335 billion left, and officials believe that amount could be leveraged up by two or even three times by offering limited guarantees against losses on sovereign bonds.

If the fund can leverage up to $1 trillion, then the International Monetary Fund could provide more, perhaps as much as $335 billion, which could then also be leveraged. In this plan, the I.M.F. would function as a credible vehicle for investment. Individual European central banks, for instance, could lend money to the organization that could then be used to enlarge the bailout fund.

There is discussion as well of the I.M.F.’s creating a special fund for surplus countries like China, Brazil or Russia to invest.

The idea is to create a cumulative fund big enough to protect Italy, at least, which European and American officials regard as solvent, but which has a total debt of $2.6 trillion.

At the same time, Mario Monti, Italy’s technocratic prime minister, has announced a $32 billion package aimed at showing the markets that Italy is serious about managing its debt, and will balance its budget by 2013. Among other things, he called for reintroducing an unpopular property tax, raising the retirement age, hiking the value-added tax and cutting payments to regional governments, which could then be forced to lay off workers.

Other matters still to be resolved, European and American officials say, include a final deal with the private sector and banks on the restructuring of Greek debt, in which the private sector is supposed to take a 50 percent “haircut” on the face value of Greek bonds. There are also continuing negotiations over how to recapitalize European banks to protect them from sovereign debt losses and to ensure that they continue to make loans, both to one another other and to customers.

As crucial as this summit meeting will be for market confidence, Mrs. Merkel loves to repeat, “There is no magic wand” or “single act” to solve the euro crisis. As she told German lawmakers last week, “It is a long process, and that process will take years.”