Merkel Returns to Crisis as Bond Buying Remains in Focus

By Patrick Donahue - Aug 12, 2012

German Chancellor Angela Merkel returns to the front line of the European debt crisis this week as the bloc’s leaders squabble over measures including bond purchases to relieve concerns the single currency may fragment.

Merkel ends her summer vacation and travels to Canada Aug. 15-16 for talks with Prime Minister Stephen Harper as a spiraling euro crisis threatens to constrain the global economy. With the region’s leaders awaiting a German high court decision on bailout funding next month, they’re struggling to smooth divisions over a European Central Bank plan to buy the bonds of indebted nations.

“It makes no sense for the ECB to start financing” Spain and Italy, ECB Governing Council member Luc Coene said in an interview with newspapers De Tijd and L’Echo published on Aug. 11. “It would only lead to the ECB taking on the whole public debt of Spain and Italy onto its balance sheet.”

ECB President Mario Draghi suggested earlier this month the central bank could purchase sovereign debt alongside euro-area bailout funds. While the plan offered Europe an initial respite from the turmoil, Spanish and Italian yields climbed last week on concern that a debt-purchasing program won’t be sufficient to curb the crisis. Concern over the euro may compound flagging global growth following reports last week that China’s exports and industrial production slowed.

Spanish two-year note yields last week posted a first weekly gain since the five days ended July 20, while the Italian two-year rate also climbed. The euro slid from a monthly high against the U.S. dollar of $1.2444 on Aug. 6, closing the week at $1.2289.

Divided ECB

The ECB said last week that it would undertake bond purchases only if troubled nations promise measures to improve their economic health. Coene, who also heads Belgium’s central bank, told the two Belgian newspapers that ECB officials are divided on what conditions should be agreed.

The policy maker said the central bank’s experience a year ago demonstrates why the ECB is reluctant to step in.

“We haven’t forgotten what happened in August of last year: We bought Italian bonds and right after that the Italian government reneged on its pledges,” Coene was quoted as saying. “The conclusion is clear: When you take away the market pressure, you take away the pressure on politicians to act.”

ECB purchases won’t return investor confidence in Spain and Italy, he said, attributing the rise in bond yields to a lack of trust in those countries to repair their economies.

Italian Economy

“Every board member, including the Spanish and Italian ones, knows that our actions will have a short-lived effect” and that market turmoil “will stop only when there’s no more Spanish and Italian bonds in the market,” Coene said.

Italian bond spreads need to retreat by the end of the year to avoid “strong” contagion to the economy, Fabrizio Viola, chief executive officer of Italy’s Banca Monte dei Paschi di Siena SpA, La Repubblica reported on Aug. 11. He urged the ECB and the region’s bailout funds to buy sovereign debt on the primary and secondary markets, the newspaper said.

Bank of England Governor Mervyn King repeated his gloomy outlook on the euro-area debt crisis. Writing in yesterday’s Mail on Sunday newspaper, he said rebalancing the British economy would be much easier if the rest of the world was growing normally.

‘No Obvious End’
“Even the rapidly expanding emerging-market economies are slowing, and the problems of the euro area continue with no obvious end in sight,” he wrote. The comments come days after the Bank of England cut its U.K. growth forecasts and said the outlook is “unusually uncertain.”

The euro’s permanent fund, the 500 billion-euro ($614 billion) European Stability Mechanism, won’t become active until Germany’s Federal Constitutional Court rules on its viability on Sept. 12. Only with a court endorsement will the German government be able to ratify the ESM treaty.

“It is not our base case that the constitutional court will block the ESM, though it will likely be a close decision,” Joachim Fels, chief economist at Morgan Stanley in London, wrote in a note to clients yesterday. Still, the judges “could well attach conditions that will make it difficult for the government to make further integration steps.”

**German Referendum**

The possibility that Germany’s high court will demand greater elector participation in euro decisions raised the prospect of a referendum in the euro area’s biggest economy, placing the country’s commitment to the currency in the hands of voters at time that polls show rising discontent with the costs of the crisis.

While Merkel has resisted the notion of a referendum, Rainer Bruederle, the parliamentary caucus leader of her Free Democratic coalition partner, told Hamburger Abendblatt last week that Germany’s role in the crisis might need to be put to a vote.

“We may come to a point where a referendum about Europe becomes necessary,” Bruederle told the newspaper. “The future development of the debt crisis will show how much the EU countries will be asked to give up sovereignty.”

Hans Michelbach, a Merkel ally from the Bavarian Christian Social Union, said the court’s decision may trigger an automatic referendum if the judges rule that the ESM and the transfer of sovereign rights require constitutional change.

“Given the rise of euro-skepticism in Germany and elsewhere, markets would likely take such a verdict by the court as a bad sign,” Morgan Stanley's Fels wrote.

**Greek Talks**

The monthlong wait for the ESM decision will be paralleled by anticipation on whether Greece continues to receive euro rescue funds. Greece’s troika of international creditors -- the ECB, the European Commission and the International Monetary Fund -- will return to Athens in early September to resume talks as Greek Prime Minister Antonis Samaras seeks to hammer out 11.5 billion euros in budget cuts for 2013 and 2014.

German Vice Chancellor Philipp Roesler, who drew international criticism last month for resurrecting the possibility of a Greek exit from the euro, told Focus magazine that such a scenario would be “manageable,” echoing a statement by Luxembourg Prime Minister Jean-Claude Juncker.

“Hardly any of our offers have been taken up by the Greeks,” Roesler told Focus Aug. 11, referring to economic support put forward by the German government and industry.

The ECB’s Coene said a Greek exit “would be the worst solution,” adding in the interview that “it would raise a question about euro membership for everybody, not only for Greece.”

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