BERLIN—German Chancellor Angela Merkel faces growing calls to soften her resistance to a potentially powerful weapon in Europe's debt crisis: euro-zone bonds that would raise appeal for investors but make each euro member liable for the debts of the others in the currency club.

Adding to the pressure is a market rout as investors flee nearly all euro-zone bonds other than German bunds. Spain on Tuesday was forced to pay a euro-era record 5.11% yield on three-month bills at an auction of treasury bills—more than double the rate it paid at an auction last month.

In a further sign of strain, banks' borrowing from the European Central Bank soared to the highest level since 2009, the central bank said Tuesday. The ECB said it allotted €247.2 billion ($333.5 billion) in seven-day financing to banks.

French bond yields also shot up in a sign that the debt crisis was continuing to spread to large, top-rated countries. The Dow Jones Industrial Average fell 53.59 points to 11493.73, and investors fled to the safety of Treasurys, sending the yield on the 10-year note to 1.945%, down 0.018 percentage point.

Asian markets fell Wednesday morning, with Australia's SP/ASX 200 down 1% and South Korea's Kospi Composite down 1.1% in early trading. Markets were closed in Japan for a holiday.

Ms. Merkel on Tuesday stressed that joint debt issuance isn't the right response now. "The discussion of euro bonds in the midst of the crisis is inappropriate," she said.

Germany has never categorically ruled out the joint issuance of bonds by the euro's 17 national governments, known as euro bonds. But Berlin insists that before euro members collectively raise financing on the open market, they must create rules that force each country to exercise fiscal discipline—or pay a heavy price.

However, many analysts say Ms. Merkel may no longer have the luxury of time to wait for euro-zone economies to heal before working on long-term changes Germany believes are needed to prevent such a crisis from recurring.

Faced with the choice of using any means necessary to save the euro or allowing Italy to default as investors demand an ever-higher risk premium for Rome's debt, Ms. Merkel may be forced to abandon her opposition to extraordinary defensive measures, economists say. Italian bond yields on Tuesday rose to...
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Santander's Capital Move

The International Monetary Fund has introduced new liquidity lines to help euro-zone countries under pressure to shed their pesky liquidity worries and "break the chains of contagion." W.S.J.'s Thorold Barker visits Mean Street to discuss.

6.75%, up 0.11 percentage point.

The European Union's executive arm on Wednesday is expected to present proposals that would link the issuance of euro bonds with new powers for the European Commission to intervene in the formation of national budgets—enforcing the kind of discipline Germany is calling for.

The commission is expected to call for more-intrusive monitoring of countries facing severe financing problems and to outline ways the euro zone could combine its financial muscle.

"It is clear that any type of euro bonds would have to go in parallel, hand in hand, with a substantially reinforced fiscal surveillance and policy coordination as an essential counterpart," Olli Rehn, the European Commissioner for Monetary Affairs, said in a speech in Berlin on Tuesday.

Germany hasn't signaled it is ready to accept euro bonds in the near term in return for such budget controls. Collective borrowing would likely increase Germany's cost of servicing its public debt.

Many lawmakers in Ms. Merkel's ruling center-right coalition are deeply skeptical about joint euro-zone liability for debts, which they fear would reduce pressure for southern European countries to rein in government spending. "The moment we let up the pressure, those countries that have such problems will become complacent," German Finance Minister Wolfgang Schäuble said Tuesday.

In addition to being a hard sell to Germany's lawmakers and voters, euro bonds may require amending the country's constitution, requiring a broad consensus among political parties in the euro zone's biggest member.

The European Commission wants governments with funding problems to be subject to frequent monitoring, and is suggesting that other euro-zone member states could "recommend" a government seek a bailout program, effectively forcing it to do so. That could be seen as a trade-off with Germany, granting Berlin a way to force a country into supervision in exchange for collective debt issuance.

Failure to comply with an EU program would entail cutting off EU funding to that country, and the intensified monitoring would continue until three-quarters of a country's bailout loans were repaid. That suggests bailout recipients such as Greece could face special monitoring for a decade or more.

Ms. Merkel is expected to discuss these issues at a meeting in Strasbourg, France, on Thursday with French President Nicolas Sarkozy and newly appointed Italian Prime Minister Mario Monti. The French and German leaders have asked Mr. Monti to come up with "new ideas" to battle the crisis, which now threatens to engulf Italy. Mr. Monti, who is an advocate of euro bonds, said Tuesday that they "must not be seen as a way to elude financial discipline, but as a tool that can contribute even more strongly to render markets more stable and balanced."

The commission's paper will suggest three euro-bond options: two would require changes to the EU treaty because they require stronger governments to guarantee bonds of weaker ones. A third option with no cross-country guarantees could be introduced fairly quickly, without changing the treaty—though it would deliver fewer benefits.

The paper acknowledges that unless euro bonds are accompanied by tough budget rules they risk encouraging governments to be profligate.

Last week, the German chancellor acknowledged none of the measures adopted by EU leaders in a series of tireless summits over the past two years has been sufficient to stop the spread of financial contagion.
At a meeting of leaders of Group of 20 industrial and developing nations earlier this month, Ms. Merkel appeared close to approving a plan that would have drawn on the financial reserves of the euro zone’s central banks. She was blocked by German Bundesbank President Jens Weidmann.

Mr. Weidmann, a staunch defender of central-bank independence who rejects any move to make the European Central Bank the lender of last resort to euro governments, also indicated what it would take for Germany to compromise on the issue of euro bonds.

Speaking at the same conference as Ms. Merkel and Mr. Rehn, Mr. Weidmann said one alternative to solving the crisis is to create a fiscal-policy union in which national parliaments would give up absolute control over their national budgets. Euro-zone members would create a common fiscal policy and violators would be penalized by suffering a “substantial restriction of national sovereignty,” he said.

"In my view, a comprehensive expansion of collective liability is only imaginable at the end of an integration process if these conditions are fulfilled, if liability is coupled with powers of intervention," Mr. Weidmann said.

The dilemma that Germany faces is that the gathering capital flight from Europe’s government bond markets may leave too little time for a long integration process to be completed.

The commission proposals are an implicit acknowledgment that the crisis response so far is failing to stem the turmoil. Pessimism is growing about the success of the planned expansion of the European Financial Stability Facility, the euro zone’s bailout fund. Meanwhile, more and more euro-zone governments are seeing borrowing costs rise as investors focus not just on the risk of default, but on the risk of a break-up of the euro.

—Chris Emsden, Andreas Kissler and Neelabh Chaturvedi contributed to this article.

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