Spain Aid Faces Diplomatic Tangle

Madrid's New Willingness to Push Ahead on Bailout Request Meets Questions; Moody's Confirms Investment-Grade Rating

By MARCUS WALKER in Berlin and ILAN BRAT and DAVID ROMÁN in Madrid

A potential Spanish request for financial aid is becoming caught up in tangled diplomacy between euro-zone capitals, despite Madrid's new willingness to push ahead.

A day after a senior Spanish official told reporters that German concerns were preventing Madrid from seeking assistance, German officials insisted Spain hadn't indicated it wants aid. Italy, meanwhile, continued to urge Spain to apply for help in the hope that the step would ease market pressure on its own bonds. Germany worries that a request may have the opposite effect, by fanning investor fears that Italy will be next in line to need a bailout.

In Gijon, northern Spain, shipyard workers demanding back wages set fire to barricades on Tuesday. Protests in Spain have widened as the economy has languished.

Obstacle Course

Spain would face several hurdles to qualify for aid from the European Central Bank:

- Madrid must first request an 'Enhanced Conditions Credit Line' from the euro zone's bailout fund.
- If other euro countries accept the request, Spain must negotiate binding economic and budget overhauls with Europe and IMF.
- Other euro countries must approve the deal.
- The ECB—if satisfied with the results of these previous steps—would step in to buy Spanish bonds in the open market.

In a reprieve for Madrid on Tuesday, Moody's Investors Service said Spain's sovereign-debt rating remains investment grade, concluding a review by the ratings firm that some had feared would result in a downgrade to junk status. Such a cut would have made it harder for Spain to win back foreign investors and could have forced it to speed up bailout plans.
At issue for Madrid are the hoops it must jump through to get the European Central Bank to intervene in Spain's bond market, bringing down the country's borrowing costs. The ECB has indicated it will buy Spanish bonds only if Madrid first applies to the euro-zone governments' bailout fund for a line of credit, called an "Enhanced Conditions Credit Line."

To get an ECCL, Spain would have to sign a memorandum laying out economic overhauls and budget targets, and it would need the consent of Germany and other euro-zone governments. The ECB and Germany are also likely to insist that the International Monetary Fund help design the program, to ensure that Spain's policy overhauls are rigorous.

Spain's government, fearful that the whole procedure would entail a loss of face and a domestic political backlash, has dithered for weeks over whether to request aid. Officials from Italy, France, the European Commission and the IMF are pressing Spain to make the move, before the current calm in European financial markets evaporates.

Senior Spanish officials signaled on Monday and Tuesday that Madrid is now more open to applying for an ECCL. One reason for the shift, the officials said, is that Spain no longer fears that European authorities and the IMF would impose significant extra fiscal austerity on the country as a prerequisite for aid. Many IMF and European officials now agree that overzealous budget cuts deepen recessions more than they strengthen a country's finances.

Markets' rising hopes that Spain would request a credit line and obtain ECB support helped Spain issue new debt on Tuesday. The country sold nearly €4.9 billion ($6.3 billion) in Treasury bills, more than planned, at lower interest rates than it offered a month ago. Spain, which must repay about €20 billion of maturing bonds at the end of October, also plans to sell as much as €4.5 billion of new bonds on Thursday.

The threat of downgrades to its credit rating is putting pressure on Spain to seek European help. The two biggest ratings companies, Moody's and Standard & Poor's Corp., now rate Spain's government debt just one notch above junk status. Further downgrades could make it very hard for Spain to lure back foreign investors who have fled its bond market since 2011.

But Spanish officials say they want to be sure that other euro-zone countries will accept their aid request before they make it, because a "no" could trigger renewed turmoil in markets. Germany is balking, Spanish officials say.

Aides to German Chancellor Angela Merkel have admitted in recent weeks that they would rather Spain didn't ask for aid. Among the chancellor's concerns, say people familiar with her thinking: An aid request, and ECB intervention, might only stabilize markets for a few months. After that, Spain might need a bigger bailout, and markets might train their sights on Italy.

But Italian Premier Mario Monti told reporters in Milan last week that he doesn't share Germany's concern. Some people believe "speculators will simply move like a pack of wolves to the next target" if Spain receives a credit line and ECB support, Mr. Monti said. "But I think that once it is understood that the mechanism exists and works, this will make speculation less aggressive," he added.
A Spanish request for aid “would be positive for the whole euro-zone and therefore for us too,” Maria Cannata, the Italian Treasury official in charge of debt issuance, said in a television interview Tuesday.

Germany is also wrestling with the need for extra financing for Greece, and trying to persuade other reluctant euro members to accept tougher spending controls.

Ms. Merkel's other concern about a Spanish request is closer to home: She would face a likely backbench rebellion in Germany's parliament, the Bundestag, where bailout-weary lawmakers would have to agree to the credit line for Spain.

Ms. Merkel may also have to ask parliament for more-generous financing for struggling Greece in coming weeks, as well as for a bailout for Cyprus. German officials say they want to bundle all of these cases into one parliamentary vote, if they can't avoid the Bundestag.

German officials said Tuesday that they see no signs that Spain is closer to asking for aid. Spanish Prime Minister Mariano Rajoy reassured Ms. Merkel in a phone call on Tuesday that Spain isn't about to make the request, said people familiar with the matter.

Ms. Merkel is likely to face an easier time in the Bundestag if she can also show that Germany is imposing stricter budget discipline on other euro nations. German Finance Minister Wolfgang Schäuble told reporters late Monday that Germany wants European officials in Brussels to have veto powers over national tax and spending plans. Other euro members, including France, are reluctant to cede that much sovereignty over their budgets.

Officials at the ECB—whose support in the market is the real prize for Spain—remain skeptical of Madrid's intentions, after Spanish media reports suggested the government wants the central bank to keep Spanish borrowing costs below a specific target, a so-called yield cap. The ECB has said it will take a more-flexible approach if it intervenes in bond markets.

The senior official at Spain's finance ministry said late Monday that Spain isn't demanding the ECB impose a ceiling on Spanish interest yields, or on the difference between Spanish and German borrowing costs. "Spain will not pressure the ECB in any way," the official said.

—Alessandra Galloni, Art Patnaude, Jonathan House and William Boston contributed to this article.

Write to Marcus Walker at marcus.walker@wsj.com and Ilan Brat at ilan.brat@wsj.com