European Union leaders failed to get all of the bloc's 27 members to back a change in the EU treaty to tighten their fiscal coordination as a decisive summit in Brussels ended its first day in the early hours Friday.

The leaders, who are still deeply divided over key elements of their crisis strategy, decided they would move to form a pact among at least 23 of the members to tighten rules on national fiscal policy.

But details of the proposed treaty remained to be settled. The U.K. stood aside—after Prime Minister David Cameron failed with what officials said was a "shopping list of demands" designed among other things to protect national supervision of its banks—while Hungary, Sweden and the Czech Republic reserved their positions.

"We will achieve the new fiscal union. We will have a euro currency within a stable union," German Chancellor Angela Merkel said at the end of the meeting. "We will have stronger budget deficit regulations for euro-zone members."

European Central Bank President Mario Draghi, whose reaction to the summit is being closely watched by investors in the region's beleaguered bond markets, said early Friday: "We came to conclusions that will have to be fleshed out in coming days. It's going to be a good basis for a fiscal compact for the euro area."

Some European officials said that an agreement that didn't include all 27 members would be weaker, but the proposed deal would include all 17 members of the euro zone. The two-day summit will resume Friday.

On Thursday, the ECB dashed investor hopes it would signal strong action to shore up the euro zone's ailing bond markets.

The central bank decided to cut interest rates back to record lows to avert a recession and took big steps to help cash-strapped banks. But investors reacted more to the ECB's lack of any indication it would act powerfully to intervene in Europe's crumbling government-bond markets, whose collapse has been seen as threatening the euro's survival.

Mr. Draghi had also poured cold water on proposals to allow Europe's national central banks to channel money to governments via third parties such as the International Monetary Fund or Europe's bailout funds. He stressed that the ECB abides by the "spirit" of its founding charter that prohibits the central bank from financing governments.

Mr. Draghi's remarks reversed a rally in the region's government bond markets over the last week that had been spurred by the assumption of an unspoken deal: a display of committed action by euro-zone governments at the summit in exchange for a campaign of ECB government-bond buying that would push down borrowing costs for Italy and Spain.

Mr. Draghi's remarks undermined this assumption and kept the heat on EU leaders meeting in Brussels to come up with new rules for tighter
fiscal union—and to find ways to bolster their crisis-fighting tools.

Equity markets fell, as did the euro. In the bond market, yields on French, Belgian, Italian and Spanish debt moved higher. Italian bonds took an especially hard hit. The yield on Italian 2-year notes rose by 0.44 percentage point to 6.5%.

The Dow Jones Industrial Average tumbled 198.67 points, or 1.63%, to 11997.70. For a second straight day, stocks surged in the last hour of trading on reports about encouraging developments in Europe, only to be dragged sharply lower after those reports were thrown into question.

In Asia, markets fell Friday morning, with Japan down 1.6%, Australia losing 1.4% and South Korea falling 1.9%.

"We shouldn't try to circumvent the spirit of the treaty, no matter what the legal trick is," Mr. Draghi said on Thursday, referring to the proposals to recycle central bank funds indirectly back to governments. He said there is no deal in place in which the ECB would beef up its crisis response if European leaders come up with tougher fiscal reforms. ECB officials oppose government-bond purchases that would set a cap on bond yields, he said.

Mr. Draghi, in his second news conference since taking the helm of the ECB last month, wasn't expected to unveil a big government-rescue plan, especially hours ahead of the summit.

The EU leaders are debating at the summit ways to strengthen budget discipline and boost the firepower of bailout funds to help crisis-hit governments.

But, according to a person in the room, the summit opened with German Chancellor Angela Merkel emphasizing her opposition to a plan that had broad support among other countries—giving a banking license to the European Stability Mechanism, its future bailout fund. That move, which was included in a leaked draft communiqué of the meeting’s expected conclusions, would allow the bailout fund to borrow from the ECB.

There was no agreement by the close of the first day on whether to turn the ESM into a bank, although the discussion on the issue was expected to continue later Friday.

Other parts of the deal being negotiated include lifting a €500 billion ($671 billion) cap on total lending from the euro zone’s sovereign bailout funds, as part of efforts to build a stronger firewall around larger troubled economies in the euro zone. Doing so could provide up to €700 billion in lending for Italy or Spain and for bank recapitalizations across the euro zone.

Ms. Merkel also made plain her resistance to that idea, said the person present. However, leaders were moving toward agreement on bringing forward the proposed ESM start date by a year to mid-2012, officials said.

The proposal under discussion on which Mr. Draghi poured cold water is for central banks to lend €200 billion to the IMF, including €150 billion from the euro zone, that the IMF could then use to bolster troubled bond markets.

The €150 billion would come from bilateral loans to the IMF...
The European Central Bank on Thursday returned its benchmark refinancing rate to a historic low of 1%, fully reversing its much-criticized increases earlier this year, Stephen Fidler reports on Markets Hub.

ECB President Mario Draghi addresses the media on Thursday.

Group, a political consultancy based in New York, said, "The ECB's opposition to IMF loans via national central banks has been known for some time. Draghi's comments aren't new, and they still don't mean these loans won't get done."

Under the proposal, half of the money could be sent to a special IMF fund reserved for lending to the euro zone, while the other half could go to a general resources account at the IMF, available for precautionary and other lending to governments around the world, officials said.

Although Mr. Draghi didn't rule out central banks providing money to the IMF for its general purposes, he said that if the funds are simply used to help euro-zone countries, "we do not think this is compatible with the treaty."

"Draghi's strategy is to not commit to [more aggressive] bond buying, but instead put pressure on policy makers to do their job," said Michael Heise, chief economist at German insurer Allianz.

The ECB expects the 17-member euro bloc's economy to expand just 0.3% next year, and Mr. Draghi has said a "mild" recession is likely.

Although the current inflation rate of 3% is well above the ECB's 2% target, officials expect price pressures to ease steadily into 2012.
2013, suggesting scope for even more rate cuts.

ECB officials will also make unlimited loans available to
euro-zone banks at maturities of three years—the previous limit
was 13 months—giving banks access to medium-term funding.
The ECB said it will accept a much wider pool of collateral for
loans, and lower its reserve requirement for commercial banks to
1% from 2%.

—Tom Lauricella, Costas Paris and William Boston contributed to
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