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EU Crafts $962 Billion Show of Force to Halt Crisis (Update3) 2010-05-10 10:23:35.209 GMT

(Adds Pimco fund manager comment in fourth paragraph. For more on the debt crisis, see {EXT3 <GO>}.)

By James G. Neuger and Meera Louis

May 10 (Bloomberg) -- European policy makers unveiled an unprecedented loan package worth almost $1 trillion and a program of bond purchases to stop a sovereign-debt crisis that threatened to shatter confidence in the euro. Stocks surged around the world, the euro strengthened and commodities rallied.

Jolted by last week's slide in the currency and soaring bond yields in Portugal and Spain, European Union finance chiefs met in a 14-hour session in Brussels overnight. The 16 euro nations agreed in a statement to offer as much as 750 billion euros ($962 billion), including International Monetary Fund backing, to countries facing instability and the European Central Bank said it will buy government and private debt.

The rescue package for Europe's sovereign debtors comes little more than a year after the waning of the last crisis, caused by the U.S. mortgage-market collapse, which wreaked $1.8 trillion of global credit losses and writedowns. Under U.S. and Asian pressure to stabilize markets, Europe's governments bet their show of force would prevent a sovereign-debt collapse and muffle speculation the 11-year-old euro might break apart.

"A very thick line has been drawn in the sand," said Andrew Bosomworth, Munich-based head of portfolio management at Pacific Investment Management Co. and a former ECB official. "This is all in. What more could they have done?"

A 110 billion-euro bailout package for Greece approved last week by the EU and IMF failed to reassure investors, prompting yesterday's renewed bid to bolster the euro.

How to Pay

"It might temporarily calm nerves but questions will come back later on how they will pay for this package when all of them need fiscal consolidation," said Venkatraman Anantha- Nageswaran, who helps manage about $140 billion in assets as global chief investment officer at Bank Julius Baer & Co. in Singapore.

The MSCI World Index climbed 2.6 percent to 1,128 at 12:15 p.m. in Brussels. Standard & Poor's 500 Index futures rallied 4.4 percent. The euro appreciated 2 percent to $1.30. Crude-oil futures gained 3.4 percent.

"The message has gotten through: the euro zone will defend its money," French Finance Minister Christine Lagarde told reporters in Brussels early today after markets punished inaction last week.

ECB policy makers said they will counter "severe tensions" in "certain" markets by purchasing government and private debt, and the bank restarted a dollar-swap line with the Federal Reserve.

‘Overwhelming Force’

“This truly is overwhelming force, and should be more than sufficient to stabilize markets in the near term, prevent panic and contain the risk of contagion,” Marco Annunziata, chief economist at UniCredit Group in London, said in an e-mailed note. “This is Shock and Awe, Part II and in 3-D.”

Treasuries tumbled on investors’ increased appetite for risk, with yields on benchmark 10-year U.S. notes rising to 3.57 percent from 3.43 percent at last week’s close. German bunds also declined, sending 10-year yields up 18 basis points.

The steps came after failure to contain Greece’s fiscal crisis triggered a 4.1 percent drop in the euro last week, the biggest weekly decline since the aftermath of Lehman Brothers Holdings Inc.’s collapse. European stocks sank the most in 18 months, with the Stoxx Europe 600 Index tumbling 8.8 percent.

The ripple effect in the U.S., including a brief 1,000- point drop in the Dow Jones Industrial Average on May 6, prompted President Barack Obama to call German Chancellor Angela Merkel and French President Nicolas Sarkozy to urge “resolute steps” to prevent the crisis from cascading around the world.

Loan Package

Under the loan package, euro-area governments pledged 440 billion euros in loans or guarantees, with 60 billion euros more in loans from the EU’s budget and as much as 250 billion euros from the International Monetary Fund.

“They will have bought themselves a significant amount of time to do the right thing,” said Barry Eichengreen, an economics professor at the University of California, Berkeley.

In a step that skirts EU rules barring direct central bank lending to governments, the ECB said it will conduct “interventions” to ensure “depth and liquidity” in markets.

The purchases will be sterilized, meaning they won’t increase the overall money supply in the financial system.

“This sets a precedent for the rest of the life of the Central Bank and will have likely surprised even the most seasoned observers,” said Jacques Cailloux, chief European economist at Royal Bank of Scotland Group Plc in London. “While the ECB’s intervention might attract bad press regarding its mandate and independence, we believe that this was necessary to short circuit the negative feedback loop which was getting more and more threatening for the global economy. ”

Central Banks Buy

Central banks in Germany, France and Italy all said they began buying government bonds today. None provided further detail.

The ECB also reactivated unlimited fixed-rate offerings of three-month loans, a key tool in the ECB’s efforts to fight the credit crisis.

In Brussels, finance ministers from the 16-nation euro region -- joined by ministers from the 11 EU countries outside the euro -- raced against time to weld the contingency lending arrangements before markets opened in Asia.

Inability to craft a convincing package in time would have left deficit-plagued countries at the mercy of the “wolfpack behavior” of speculators, Finance Minister Anders Borg of Sweden, a non-euro member, said as the meeting began.

Budget Cuts

The new war chest would be used for countries like Portugal or Spain in case their finances buckle. Deficits are set to reach 8.5 percent of gross domestic product in Portugal and 9.8 percent in Spain this year, above the euro region’s 3 percent limit. Both countries pledged “significant” additional budget cuts in 2010 and 2011, which will be outlined in May, an EU statement said.

The extra yield that investors demand to hold Greek, Portuguese and Spanish debt instead of benchmark German bonds fell from euro-era highs. The premium on 10-year government bonds plunged to 343 basis points from as high as 973 basis points for Greece. It fell to 201 basis points from 354 for Portugal and to 94 basis points from 173 for Spain.

Europe’s financial leaders sought to master the euro’s stiffest test since its debut in 1999 without wheelchair-bound Finance Minister Wolfgang Schaeuble of Germany, Europe’s largest economy, who was rushed to a hospital soon after the meeting started due to an adverse reaction to new medication. Interior Minister Thomas de Maiziere got on a last-minute flight to Brussels to take his place.

Merkel’s Meeting

As Merkel’s cabinet held a late-night meeting in Berlin on the euro rescue, her party unexpectedly lost control of Germany’s most populous state in a regional election, potentially costing her a majority in the upper house of the federal parliament.

Goaded by Germany, the ministers made a fresh commitment to closer monitoring of government finances and more rigorous enforcement of the deficit-limitation rules.

The vow to push budget shortfalls below the euro’s 3 percent limit echoes promises that have been regularly broken ever since governments in 1999 set a three-year deadline for achieving balanced budgets. The euro region’s overall deficit is forecast at 6.6 percent of gross domestic product in 2010 and
6.1 percent in 2011.

Britain, the EU’s third-largest economy, won’t contribute to a euro rescue fund, though it backs efforts to restore stability, Chancellor of the Exchequer Alistair Darling said.

“When it comes to supporting the euro, that is for the eurogroup countries,” Darling told Sky News.

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