EU Sets 160 Billion-Euro Plan to Stem Crisis as Greek Default Looms
2011-07-21 19:38:38.164 GMT

(For more on Europe's debt crisis, see EXT4.)

By Simon Kennedy and Jonathan Stearns

July 21 (Bloomberg) -- Euro-area leaders redoubled efforts to end the 21-month sovereign bond crisis as they risked a temporary default to ease Greece's debt burden and erected a firewall around Spain and Italy.

Spooked by a bond market selloff last week, leaders empowered their 440-billion euro ($633 billion) rescue fund to buy debt across stressed euro nations after eight hours of talks in Brussels. The fund can also aid troubled banks and offer credit-lines to repel speculators. Leaders pledged a 160 billion euro aid package for Greece, eased the terms of its existing loans and cajoled bondholders into footing part of the bill.

The euro strengthened as officials drew concessions from Germany and the European Central Bank for a twin-track strategy to support Greece and ensure its woes don't spread. The Brussels summit is the latest in a running-battle to resolve and contain the crisis amid calls this week for tougher action from U.S. President Barack Obama and the International Monetary Fund.

"These measures are welcome because they create the best possible conditions for Greece and other peripheral countries to put their houses in order and hence limit the risk of contagion," said Marco Valli, chief euro-area economist at UniCredit SpA in Milan. "Still, the market will continue to price some probability that troubled countries will not be up to the challenge. Implementation risks to debt reduction are still considerable."

Regaining Initiative

The euro jumped 1.2 percent to $1.4379 today. Greek, Italian and Spanish bonds rose, with the yield on Greece's two- year security plunging more than 400 basis points to 33.81 percent. The yields on Spanish and Italian 10-year bonds both fell 25 basis points, dropping to 5.692 percent and 5.324 percent, respectively.

The government chiefs sought to regain the initiative after the turmoil worsened amid a spat between ECB President Jean- Claude Trichet and German Chancellor Angela Merkel over how to manage the crisis and signs Greece was backsliding on axing its budget deficit. A Bank of America Merrill Lynch poll this week showed investors cutting their European stock holdings to the lowest in more than a year.

French President Nicolas Sarkozy, speaking after the summit ended, compared the transformation of the bailout fund to the creation of a "European Monetary Fund." He also said that the measures deployed to help Greece won't be replicated to aid other countries.

New Drive

The risk is that the drive will fall prey to the same internal EU wrangling that blunted previous drives to stop the crisis. EFSF bond purchases will need to be agreed unanimously by governments, a draft statement showed earlier, and the fund may not be large enough should markets turn on Italy and Spain at the same time.

European officials tried to draw a line under the crisis in May 2010 when they set up the bailout fund and the ECB agreed to buy government bonds of stressed nations. That didn't stop Ireland and Portugal needing bailouts when splits over how to make investors participate in financial rescues prompted a new wave of bond market selling later in the year.

Today's package still doesn't "make a significant dent" in Greece's debt and may disappoint investors by failing to boost the size of the rescue fund, said Jonathan Loynes, chief European economist at Capital Economics Ltd. in London. "We doubt that this package alone will bring an end to recent contagion effects and prevent the broader debt crisis from continuing to deepen over the coming months."

Merkel Success

For now, Merkel and her allies have succeeded in their drive to make investors co-finance bailouts after voters balked at the cost of saving spendthrift nations. Banks said they will participate in bond exchanges and buybacks to help Greece, with the leaders estimating their contribution at 37 billion euros.

"Official" aid will be worth 109 billion euros, leaders said in a statement.

The ECB will remove one obstacle to another Greek rescue should Trichet drop his opposition to a default which may be declared by credit rating companies if the debt swap occurs. The ECB had until now said such a move, which would be the euro area's first, could spark a bout of financial turmoil, clashing with Merkel's position that a default could be inevitable.

Defaulted Collateral

Now, two European officials familiar with the talks say governments may guarantee any defaulted Greek debt offered as collateral at money market operations. That would enable Greek banks to keep tapping the ECB for emergency funds. The officials said the aim would be limit any credit event to a few days.

The talks were also attended by Deutsche Bank Chief Executive Officer Josef Ackermann, BNP Paribas SA counterpart Baudouin Prot and Charles Dallara of the Institute of International Finance.

Trichet may gain solace if leaders widen the remit of their bailout fund as he has repeatedly sought since the ECB suspended its own bond buying program in April amid concern it was doing the work of governments. Germany previously rejected broadening the European Financial Stability Facility, whose size was beefed up as recently as last month.

The facility may also start passing money to countries to support banks a week after stress tests on 90 financial institutions put as many as 24 under pressure to show they can raise capital.

The credit lines would allow it to lend to nations before markets freeze, mimicking a system introduced by the IMF for states that start losing investor faith even though they have relatively sound economies.

Capitals will have to ratify the facility's new powers, posing a potential obstacle given domestic critics in Germany, Finland and some other AAA-rated sovereigns.

Leaders dumped a suggestion to finance Greek aid through a tax on banks. While they signaled no shift toward issuing joint bonds, Germany's Deputy Foreign Minister Werner Hoyer said in an interview late yesterday that it may eventually back the concept "if we further develop the European Union towards a political union."

For Related News and Information:
Top Stories: TOP <GO>
Top Fixed-Income News: TOP BON <GO>
Bond Yield Forecasts: BYFC <GO>
Top Italian news: ITAT <GO>
Top Economy stories: TECO <GO>

--With assistance from Lorenzo Totaro, Angeline Benoit, David Tweed, Helene Fouquet, Stephanie Bodoni, Rebecca Christie and Tony Czuczka in Brussels, Rainer Buergin in Berlin, Maria Petrakis in Athens, Sandrine Rastello in Washington, Matthew Brown in London and James G. Neuger in Budva, Montenegro.
Editors: John Fraher, Craig Stirling

To contact the reporters on this story:
Simon Kennedy in Brussels at +44-20-7330-7086 or skennedy4@bloomberg.net

To contact the editors responsible for this story:
Craig Stirling at +44-20-7673-2841 or cstirling1@bloomberg.net