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ECB Buying May Reach $1.2 Trillion in Creeping Fiscal Union (1)
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(Updates with bonds in fifth paragraph, economist quote in sixth paragraph. See EXT4 for more on Europe's debt crisis.)

By Andrew Davis

Aug. 8 (Bloomberg) -- The European Central Bank's move to buy Italian and Spanish bonds to tame the region's debt crisis marks a step toward the kind of fiscal union that Germany has opposed since the founding of the single currency.

While investors and economists say tighter fiscal ties and increased transfers to the financially weak euro states will be needed to end the financial contagion, purchases of Italian and Spanish debt that Royal Bank of Scotland Group Plc estimates may eventually reach 850 billion euros ($1.2 trillion) threaten fresh political fault lines.

"This huge-risk pooling exercise will not come easily and the risk of political fallout will be large," Jacques Cailloux, chief European economist at RBS, wrote in a note. "This might be the necessary and painful step required to pave the way for the creation of a common debt instrument, the quid pro quo for this might be the loss of fiscal sovereignty."

The unwillingness of euro leaders to forge a U.S.-style federal fiscal union with the monetary union that now joins 17 states has been a handicap that has fueled economic imbalances in the region, analysts and investors including billionaire George Soros have said. Germany, the biggest euro economy, has long resisted such a set-up, saying it would discourage member states from enforcing budgetary rigor.

German Opposition

"We don't need a fiscal union and we should oppose it because that would mark a dissolution of responsibilities," Michael Meister, the finance spokesman for Chancellor Angela Merkel's Christian Democrats, said in an interview today.

The yield on Italy's 10-year bond fell 82 basis points to 5.277 percent and the Spanish yield slid 89 basis points to 5.16 percent, the biggest one-day drops since the start of the euro.

"You can argue that markets in a sense are pushing toward fiscal integration," said Fabio Fois, economist at Barclays Capital in London. "It's really, really still a long way off."

The outcome of Europe's crisis-fighting effort may determine whether the euro evolves or runs aground on the concern that its members are too diverse to be united in one currency if some aren't willing to abide by the rules and others won't aid those in trouble.

Trichet, one of the architects of the Maastricht Treaty that established the euro, said in June that he favored a European Finance Ministry and giving the EU veto powers of national budgets.

'Too Bold'?

“Would it be too bold, in the economic field, with a single market, a single currency and a single central bank, to envisage a ministry of finance of the union?” Trichet said in a speech in Aachen, Germany.

German parliamentary leaders rejected a bid last week by European Commission President Jose Barroso to increase the euro’s 440 billion-euro bailout fund, the European Financial Stability Facility, which was set up last year to prevent the crisis that began in Greece from spreading. About 256 billion euros have been committed to Greece, Ireland and Portugal.

A Merkel coalition ally, the Christian Social Union, “will not support this,” Horst Seehofer, chairman of the party, said yesterday. The plan “can’t seriously be desired by anyone.”

Merkel allies also repeated their opposition to bonds sold jointly by euro nations. Klaus-Peter Flosbach, the financial- policy spokesman in parliament for Merkel’s bloc, said they “don’t solve the structural problems, but only move them to the future.”

In Italy, Prime Minister Silvio Berlusconi is being criticized for effectively relinquishing sovereignty to win outside financial support.

‘Political Downgrading’

The government in Rome has ceded power to financial markets and officials in “Brussels, Frankfurt, Berlin, London and New York,” former European Union competition commissioner Mario Monti wrote in an editorial in Milan’s Corriere della Sera newspaper yesterday. The result is a “political downgrading”
for Italy that will damage potential economic growth, he wrote.

The ECB bought Italian and Spanish government bonds today, spurring declines in their yields, according to five people with knowledge of the transactions. Trichet said after an emergency conference call yesterday with euro-region central bank governors that the ECB would “actively implement” its bond buying program.

The bond-buying decision, which came as EU leaders push their legislatures to approve the additional firepower for the EFSF agreed on July 21, reflects its status as the only institution in the 27-nation EU able to act fast enough to placate bondholders.

Debt Purchases

The ECB has already bought 77 billion euros of Greek, Portuguese and Irish debt, according to central bank data. Now the ECB and the EFSF, which is due to take over the bond-buying once the July 21 overhaul is ratified, are faced with trying to shore up Italy, with 1.8 trillion euros in debt, more than Spain, Greece, Ireland and Portugal combined.

Signatories of 1991’s Maastricht Treaty dodged the issue of economic union as countries insisted on maintaining control over their own purse-strings and tax policies. In doing so, they ignored the Bundesbank’s call for a “comprehensive political union’” and instead imposed limits on budgets and debts that have never been enforced.

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