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Merkel Shifts Her Stance as Crisis Destroys Taboos: Euro Credit  
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(See EXT4 for more on the European debt crisis.)

By Tony Czuczka

Sept. 27 (Bloomberg) -- German Chancellor Angela Merkel has stepped up her defense of the euro and toned down calls to punish Greece for its fiscal sins as the region's debt crisis spread to Europe's biggest economies.

Since rising Italian and Spanish bond yields forced the European Central Bank to start buying the debt last month, Merkel has signaled she wants the region to think beyond the turmoil radiating from Greece and act more like one country.

Rates on two-year Greek notes were 70.1 percent at 1:40 p.m. in Berlin, down 106 basis points from yesterday.

The shift in Merkel's strategy toward closer economic and financial union and a break from taboos such as flat rejection of euro-area bonds reflects the pressure on Europe to counter increasing speculation the 17-nation euro may splinter. The scale of the task was illustrated yesterday when the currency fell to a decade low against the yen and the weakest in eight months versus the dollar.

"We think the German government now has the right sense of urgency," Andre Wilkens, who heads the Berlin office of the Stiftung Mercator, an Essen-based public-policy group, said by phone. "And it is high time." Mercator was one of seven groups, including foundations affiliated with Allianz SE, BMW AG and Bertelsmann AG, that urged Merkel in a December 2010 open letter to work for economic union in Europe.

Merkel hosted Greek Prime Minister George Papandreou for talks in Berlin today as credit-default swaps show a more than 90 percent chance that Greece won't meet its debt commitments. By contrast, German swaps signal a less than 10 percent chance that the nation will fail to adhere to its obligations.

#### German Bonds Fall

German bonds fell as European stocks and debt from cash-strapped nations such as Spain and Italy rallied today on speculation policy makers will step up crisis-fighting efforts.

Her emphasis on the cost to Germany, the world's second-biggest exporter after China, of failing to contain the crisis that began in Greece in 2009 underscores the risk to Europe's largest economy and her chances of re-election in 2013.

"Whatever Germany offers to help, we will offer, whether through private business or through political and administrative capabilities, in the spirit of friendship, in the spirit of partnership and not in the sense of imposing something," Merkel said today in a speech to German industrialists.

'A Lot of Vacation'

That contrasts with a comment earlier this year. "The point is that in countries like Greece, Spain and Portugal you shouldn't be able to retire earlier than in Germany. Everyone should make about the same effort," she said May 17. "We can't have one currency and then some get a lot of vacation and others very little."

The switch in emphasis followed Merkel's return from a three-week summer break as the difference between French and German bond yields soared to a record and the ECB demanded Italian austerity measures as a condition for buying its debt.

Since then, Merkel, the biggest contributor to European bailouts, has advocated closer financial and economic coordination, saying Sept. 9 that deeper integration "is the only way forward for Europe" to escape the crisis. Countries sharing debt in the form of joint bonds might be possible in the "distant future," she said on Aug. 21.

"It's a sea change," Ulrike Guerot, a Berlin-based analyst at the European Council on Foreign Relations, said in an interview. "You need to think of a system that will be immune to attacks from the markets. We are moving in this direction."

#### Exit Concern

The push may be too late to convince investors. Greece's exit from the euro area "has become more likely recently," threatening to unravel the common currency, Willem Buiter, chief economist at Citigroup Inc. in London, said in a Sept. 13 note. "When Greece can exit, any country can exit."

Faced with public anger at bailing out other euro countries, Merkel is stepping up her defense of a more united Europe before German lawmakers vote in two days on an enhanced European rescue fund. Greece aims to receive its next bailout payment in October to avert default.

Merkel can claim some success for her drive toward economic integration: France, Italy and Spain have all committed to follow Germany's example and lock deficit limits into their respective constitutions.

Euro nations will probably move "slowly (and painfully) towards some kind of fiscal integration," London-based UBS AG analysts, including Stephane Deo, said in a Sept. 6 note to clients.

#### Euro Bonds

Keeping the euro area together may include limited issuance of euro bonds "for specific purposes" as part of "the price of fundamental design defects in the original monetary union," Citigroup's Buiter and Ebrahim Rahbari said in a Sept. 9 report.

With seven state elections this year out of the way and none on the calendar until next May, Merkel may now be freer to focus on the big picture. Playing on Germans' dissatisfaction with the euro didn't help her Christian Democratic Union in Mecklenburg-Western Pomerania, where Merkel has her home district. Her Free Democratic coalition ally dropped out of the Berlin city legislature after the party campaigned against euro bonds and national FDP leaders questioned further aid to Greece.

As the Free Democrats flirt with an anti-bailout stand to try and reverse a collapse in national support, Merkel's Christian Democrats, including her political mentor, Chancellor Helmut Kohl, are pressing

her to think beyond national limits and define the more-common economic policy she says is needed to save the euro.

'No Choice'

"We must not make the mistake of acting as if or letting ourselves be persuaded that this is mainly a question of money," Kohl said in an article in this month's issue of the German foreign-policy journal *Internationale Politik*. Germany "has no choice if we don't want Europe to break up."

Criticism of Merkel's stance, however implicit, may have helped flush out her European credentials and crystallized her crisis-fighting strategy, said Gerd Langguth, a University of Bonn political scientist and Merkel biographer.

"The chancellor's basically pro-European attitude has been called into question," Langguth said by phone. "She's carrying the tradition of the CDU as the party of Europe in Germany. Now she wants to show the flag."

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