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Europe’s New Budget Rigor, ECB’s Challenge

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European leaders’ blueprint for a closer fiscal union to save their single currency left the onus on central bankers to address investor concerns that Italy and Spain would succumb to the two-year-old financial crisis.

On the 20th anniversary of the Maastricht summit that created the euro and 19 months since leaders forged their first plan to contain the debt turmoil, leaders added 200 billion euros ($267 billion) to their warchest and tightened rules to curb future debts. They sped the start of a 500 billion-euro rescue fund to next year and dropped a demand that bondholders shoulder losses in rescues.

While European Central Bank President Mario Draghi hailed the accord struck at all-night talks in Brussels, investors urged him to expand his crisis-fighting arsenal to ensure debt- addled nations can pay their bills. Italian and Spanish bonds fell even as the ECB was said to be buying them in the market.

“The leaders have now defined the end point they want to reach in terms of fiscal governance, but it’s a long way to go there,” Thomas Mayer, Frankfurt-based chief economist at Deutsche Bank AG, told Bloomberg Television. “We’ll probably see more near-term tension and that will probably then trigger a more hands-on intervention by the ECB.”

Leaders set a deadline of March for agreeing the language of the new rulebook and for reassessing plans to cap the overall lending of their permanent rescue facility at 500 billion euros.

The summit’s fiscal pact sets Europe on the path to a “lastingly stable euro,” German Chancellor Angela Merkel told reporters. “The breakthrough to a stability union has been achieved.”

U.K. Excluded

In a clash that may reshape Europe’s balance of power, the euro users took the novel approach of enshrining the debt rules in a new treaty that leaves out the U.K.

instead of amending EU agreements that date back to the 1950s. Nine of the 10 non-euro members -- Denmark, Poland, Bulgaria, Hungary, Sweden, the Czech Republic, Latvia, Lithuania and Romania -- indicated they may follow suit after consulting with their parliaments.

The trigger was the refusal by U.K. Prime Minister David Cameron to back a 27-nation pact without ironclad guarantees of a British veto right over future financial regulations. Cameron called them a threat to London's standing as Europe's leading financial center.

Italian Yields

Investors gave a mixed reaction. European stocks climbed, while the euro erased gains on speculation authorities will struggle to institute their agreements. Yields on Italy's 10- year notes rose 8 basis points to 6.53 percent, while Spain's gained 3 basis points to 5.85 percent.

Draghi praised a "very good outcome" a day after he damped expectations that a deal would prompt the ECB to step up its bond-buying after so far spending 207 billion euros.

His concern is doing so would muddy the divide between monetary and fiscal policies, while lessening pressure on governments to strengthen budgets. The ECB is instead focused on reviving bank lending and yesterday cut interest rates, offered banks unlimited cash for three years and loosened collateral rules for loans.

"Markets are focused on how do sovereigns and banks get funding in the early parts of next year," said David Mackie, chief European economist at JPMorgan Chase & Co. (JPM) "The ECB did more than expected for banks yesterday, but people are still unsure about the sovereigns."

Euro Debts

Euro-area governments have to repay more than 1.1 trillion euros of long- and short-term debt in 2012, with about 519 billion euros of Italian, French and German debt maturing in the first half alone, data compiled by Bloomberg show. European banks have about $665 billion of debt coming due in the first six months, according to Citigroup Inc., based on Dealogic data.

Holger Schmieding, chief European economist at Berenberg Bank in London, said the “avalanche” of refinancing needs in the next two months means the crisis could worsen and “the ECB would then finally be forced to step up its anti-crisis response to save the euro and itself.”

Given his view that the ECB is unlikely to drive yields much lower or cap them, Citigroup economist Juergen Michels said he expects a “deep euro-area recession and strained financial markets” in 2012 with the region’s economy contracting every quarter.

Another test will be the response of credit-ratings agencies. Standard & Poor’s, which this week put Germany, France and 13 other euro-area nations on review for a downgrade, said it will study the summit implications and “impact on the growing systemic stresses we identified.” While a “unified stance” could prompt delay, rating cuts remain possible within the next three months, said Joerg Kraemer, chief economist at Commerzbank AG in Frankfurt.

Untested Territory

In putting an extra 200 billion euros on the line, European governments for the first time extracted a contribution from the euro region’s national central banks, getting them to lend 150 billion euros to the International Monetary Fund’s general resources. Non-euro EU states will chip in around 50 billion euros. Leaders aim to confirm within 10 days how they will channel the funds to the IMF, which would then be better able to aid troubled European states.

One potential concern for investors is funneling the cash through the Washington lender’s general account rather than a fund earmarked for Europe is that any loans it makes likely require repayment before privately held bonds.

G-20 Contributions

Europe is nevertheless counting on its downpayment to attract reserve-rich emerging markets such as China to join in the rescue, a month after efforts to solicit outside aid ran into obstacles at a Group of 20 meeting.

“We can contribute if some conditions are met,” Sohn Byung Doo, director general of the G-20 bureau at South Korea’s Finance Ministry, said in an interview today. China, holder of the largest currency reserves, noted Europe's "important proposals to deal with the debt crisis," Foreign Ministry spokesman Hong Lei said in Beijing.

Leaders aim to set up the permanent rescue fund, known as the European Stability Mechanism, in July 2012, a year ahead of schedule. Germany deflected a move to grant the ESM a banking license, which would enable it to multiply its firepower by borrowing from the ECB.

German Retreat

In a climbdown by Germany, the permanent fund will follow IMF practices on imposing potential losses on holders of bonds of debt-ridden states. Merkel had championed "private sector involvement" as a way of lessening the bailout burden on taxpayers, running into warnings from the ECB and investors that such a ploy fanned contagion.

"To put it more bluntly: our first approach to private sector involvement, which had a very negative effect on the debt markets, is now over," EU President Herman Van Rompuy said.

The new fiscal accord goes beyond a toughening of rules already slated to take effect next week. It would curb structural deficits at 0.5 percent of gross domestic product and require each country to establish an "automatic correction mechanism" when budgets stray from the target. This "golden rule" will be anchored in national constitutions.

The blueprint also foresaw a near-automatic disciplinary procedure for wayward countries and "more intrusive control" of taxing and spending by governments that overstep the deficit limit of 3 percent of GDP. It caps a three-month drive by Merkel to lock tighter budget discipline into treaties as part of what she calls the "deeper integration" needed to support the euro.

Investors may still ask whether the penalties against deficit sinners will have any effect and what legal instruments exist to impose them, said Kraemer at Commerzbank. He also said it remains unclear how governments will organize the funds for the IMF boost.

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