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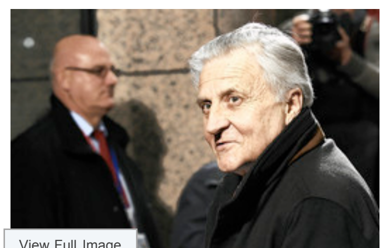
EUROPE ON THE BRINK

Currency Union Teetering, 'Mr. Euro' Was Forced to Act

By MARCUS WALKER, CHARLES FORELLE and BRIAN BLACKSTONE

LISBON—On May 6, top officials of the European Central Bank were sitting down to dinner with their spouses in the elegant Emperor's Room of the Palacio da Bacalhoa, a 15th-century estate and winery south of the Portuguese capital, when stocks in New York began a terrifying slide.



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Trichet: Life's work on the line.

The bankers' BlackBerrys lit up with frantic notes. The euro was swooning. The Dow Jones Industrial Average had plummeted 1,000 points in the "Flash Crash."

Jean-Claude Trichet, the ECB's president, feared that a fiscal mess in tiny Greece, which had consumed Europe for months, was now touching off another global financial crisis.

It was perhaps the worst of many stomach-churning moments that spring for Mr. Trichet, an urbane 67-year-old Frenchman known as "Mr. Euro" for devoting much of his 40-year career to building the common currency. It now seemed possible the panic could derail his life's work.

This account of how he and other European leaders cobbled an uneasy pact to keep the euro zone from unraveling—a patch-up that continues to show signs of strain—was based on interviews with dozens of officials across the continent.

Mr. Trichet, a child of World War II, shares his generation's intense pride in Europe's postwar achievements. He likes to show visitors to his Frankfurt office the colorful 17th-century map of Europe on his wall, to illustrate how far the Continent has come from the political fragmentation of the past.

But he is also acutely aware of the currency union's flawed construction: Despite having a single currency and central bank, national economic policies are poorly aligned. And the euro zone lacks a central authority with the power to keep national governments from spending beyond their means.

Europe's Debt Crisis

Now, profligate spending had imperiled the

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euro, and Mr. Euro was left holding the bag.

As bond investors dumped Greece's debt in the spring and financial turmoil threatened to engulf other euro-zone nations, Mr. Trichet had grown increasingly frustrated that governments hadn't heeded his warnings over the years about the perils of excessive borrowing.

That night in the winery, Mr. Trichet was stuck with two unappealing options. The ECB, using its authority to create euros, could buy the bonds private investors were shunning. That would buoy the weak governments and appease several countries, particularly France, clamoring for the ECB to take a leading role in a rescue. But it could also shatter the bank's hard-won credibility as an institution that doesn't bow to political pressure—a credibility vital to the euro's success.

The second option: Do nothing, preserve his principles, and risk watching the currency union fall apart.

Over the next three days, Mr. Trichet sought a way out of his bind by pushing Europe's leaders to overcome disunity and act. His quest ran into the euro zone's biggest political flaw: There was nobody in charge.

By the time the ECB chiefs met in Lisbon, the euro zone was in danger of coming unglued. Two weeks earlier, Greek Prime Minister George Papandreou had gone on national television from the remote Mediterranean island of Kastelorizo to publicly ask Europe for help. After much debate, European leaders and the International Monetary Fund had agreed to lend €110 billion over three years, expanding an earlier offer of €45 billion.

But even that generous sum was too late to stop the financial-market rout. Investor panic spread along the Mediterranean, infecting banks and government bonds in Spain and Portugal. Fears of default pushed Greek bond yields over 10%, a ruinous rate of interest that would make it nearly impossible for Athens to repair its finances.

Europe on the Brink

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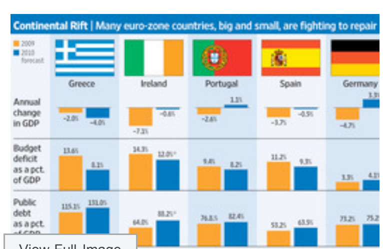
Mr. Trichet was reluctant to get involved. Earlier that day, after the ECB's monthly policy meeting, he was blunt when asked by reporters whether the bank would step in and buy debt: "We did not discuss this option," he said.

What the world didn't know: They discussed it after dinner.

With markets quaking, Mr. Trichet convened an informal conclave of the ECB's governing council in the palace's tiled wine cellar. Surrounded by bottles of the estate's Bordeaux-blend red, they debated the idea of bond purchases for about 45 minutes. The strategy split the bankers. German officials equated bond-buying with "printing money," which they argued could stoke inflation. The step was so controversial that ECB watchers dubbed it "the nuclear option."

Continental Rift

Many euro-zone countries, big and small, are fighting to repair their finances



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Despite German reservations, a clear majority in the wine cellar were prepared to go ahead. But to preserve an air of independence, they postponed a formal decision until they had seen euro-zone governments adopt tough measures of their own.

ECB officials had hoped Mr. Trichet's public rejection of the nuclear option would spur governments to do just that. Now, with the Dow plunging and markets signaling a deep sell-off in Europe the next day, central bankers feared Mr. Trichet's comments might have contributed to the general panic. (It wasn't clear yet that technical glitches at the New York Stock Exchange bore part of the blame.)

The board members, resolved to play their cards close to the vest, made no public statements

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The next day, a Friday, euro-zone leaders were due in Brussels for a quick meeting to approve the Greek package. Events were overtaking them: Lending between European banks was freezing up; investors were fleeing weaker euro nations' bonds.

French President Nicolas Sarkozy arrived early at the Brussels summit and held a series of one-on-one meetings with other euro-zone leaders, urging them to back his plan: With the crisis widening beyond Greece, the leaders should announce a massive rescue fund that same day, big enough to save any euro-zone nation from default.

The Sarkozy plan was short on details. But the force of his pitch—and his entourage of photographers and camera crews—steamrolled most of his peers. Next he swept into a meeting room where German Chancellor Angela Merkel waited. Mr. Sarkozy pressed her for a decision, declaring: "This is the moment of truth."

Ms. Merkel had accepted the need for action but knew she faced a fight in Germany to justify ever-bigger taxpayer checks for struggling euro members. She asked Mr. Sarkozy for details on how the bailout would work. Receiving vague answers, she refused to back his plan.

Mr. Trichet, also at the Brussels summit, had brought a warning: The crisis was about to claim another victim—Portugal—and governments needed to act, now. He shocked leaders by passing around a chart that showed Portugal's bonds tracking Greece's nosedive.

Mr. Trichet's appeal, delivered with customary sangfroid, led to a quarrel with his volatile fellow Frenchman, Mr. Sarkozy. The French president repeatedly pressed the ECB chief to commit to aggressive intervention in bond markets. Mr. Trichet, unwilling to show his hand, replied that the ECB didn't take orders.

As the two argued, say people present, the normally genteel central banker raised his voice with Mr. Sarkozy. Ms. Merkel calmed Mr. Trichet down by telling Mr. Sarkozy pointedly that Germany supported the ECB's independence.

Facing another Franco-German stalemate, EU President Herman Van Rompuy brokered a late-night compromise: Leaders would declare the coming of a broad European "stabilization fund," which finance ministers would flesh out over the weekend. A full announcement Sunday evening would aim to wow financial markets when they opened Monday.

The next afternoon, Ms. Merkel and Mr. Sarkozy spoke by phone. He was expecting German foot-dragging. She stunned him with a proposal: a euro-zone rescue fund of €500 billion. If Germany was going to support such a fund, it should be a blow-out that would convince markets, she had decided.

But the chancellor said she was concerned about encouraging profligacy, and worried that Germany's supreme court might strike down the fund. So she proposed tough conditions: Rescue loans would require unanimous approval by euro-zone governments. The IMF must be involved. The facility should be temporary. And there could be no collective European bonds.

JEAN-CLAUDE TRICHET

Mr. Sarkozy and the European Commission in Brussels had other ideas. At 2:45 p.m. the next day, Sunday, May 9, the 27 commissioners signed off on a draft pact. The main points: A majority vote by euro members would suffice to make money available. The commission would raise all of the funds by selling collective EU bonds. The rescue facility would exist indefinitely. An IMF role wasn't foreseen.

In her Berlin office, an irritated Ms. Merkel saw France's handwriting all over the commission's draft. Germany would have to overturn much of it before the night was out.

The effort began badly.

German Finance Minister Wolfgang Schäuble, bound to a wheelchair since being shot by a would-be assassin 20 years ago, had suffered health complications all spring. On arrival in Brussels, he suffered a severe allergic reaction to his medication. An ambulance whisked him to a nearby hospital.

At 3:45 p.m., Mr. Schäuble's deputy, Jörg Asmussen—a civil servant without the authority to sign off on €500 billion—told the other finance ministers Mr. Schäuble wasn't coming back.

The ministers looked "horrified," according to one participant, knowing that without Germany's financial muscle, the meeting would come to nothing. Christine Lagarde, France's cool-headed

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54-year-old finance minister, feared Europe was heading for failure.

Said one member of Ms. Lagarde's entourage: "When *la merde* hits the fan, it comes like fighter planes: in a squadron."

In Berlin, Ms. Merkel turned to the cabinet member she most trusted to be tough enough to impose German demands: Interior Minister Thomas de Maizière, formerly the chancellor's chief of staff. There was just one problem: Mr. de Maizière was hiking deep in rural Germany. An emergency military transport had to shuttle him to Brussels.

While his colleagues waited, a senior commission official, debating with the German delegation, tried to persuade Mr. Asmussen to let Brussels run the stabilization fund.

"Why don't you let us handle this," he said.

"Because we do not trust you," Mr. Asmussen replied.

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May 7: 'This is the moment of truth,' France's Sarkozy tells Germany's Merkel as markets quake—but she holds out for a stricter rescue plan.

Mr. de Maizière arrived in Brussels at 8:30 p.m., leaving only a few hours to reach a deal before markets opened in Asia. He set out Germany's hard line. In addition to overturning all the commission's main points, other countries would have to agree to beef up the euro zone's fiscal rules. And Spain and Portugal, which markets saw as potentially the next Greece, would have to adopt fresh austerity measures.

Spanish Finance Minister Elena Salgado, the meeting's chairwoman, balked. "This meeting hasn't been convened to discuss any specific country," she said.

While several ministers from northern Europe turned up the pressure on Spain, Mr. de Maizière pushed through many of Germany's points.

But there remained the impasse that had existed ever since the early secret planning for crisis: Should the bulk of aid come centrally from EU institutions, or take the form of bilateral loans from governments?

Mr. de Maizière said Germany's supreme court would annul any deal raising debt with EU bonds.

Other countries objected to bilateral loans. Italy, with huge public debts, said it would struggle to borrow enough from bond markets. Tiny Malta said its share of a loan—insignificant to saving Europe—would wreck its finances.

As the talks stretched deep into the night, the ministers were left without anything to eat. The EU's catering staff is a skeleton crew on Sundays, so the finance ministers shared the rubbery cellophane-wrapped sandwiches laid out for journalists. For refreshment, they received small glasses with an inch or two of beer.

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May 9: A white-knuckle day of horse-trading for Germany's Jörg Asmussen and France's Christine Lagarde.

The ministers sat around an oval table, their aides in rows of desks behind them. Banks of interpreters stood at the ready, but the ministers spoke in English to keep the meeting moving. BlackBerrys and cellphones began to die. Jean-Claude Juncker, the Luxembourg premier, puffed through one cigarette after another despite the smoking ban in EU buildings.

At 10 minutes to midnight, with trading set to start in Sydney, Ms. Lagarde said the meeting should extend its deadline to 2 a.m., to beat the opening of markets in Tokyo. "Nothing against the Australians, but they aren't that important," she said.

With a Dutch official acting as intermediary between the testy French and Germans, the ministers finally reached a compromise. The first €60 billion in the bailout fund would come from commission borrowing. But the bulk would come from a specially invented entity, registered as a financial company in Luxembourg and with a three-year life. It would lend money to crisis-hit governments, raising funds by selling bonds whose repayment would be guaranteed, portion by portion, by euro-zone governments.

The formula spared Italy and others from having to raise funds themselves, but also capped EU institutions' right to borrow on behalf of member states, a concession to Berlin.

With minutes to spare before Tokyo opened, all sides accepted a new draft statement. "Hallelujah," said Ms. Lagarde.

The elation was short-lived. The deal allowed the ECB to press ahead with its bond-buying plan, and the package of EU measures has helped quell the panic. But four months later, the root causes of the Greek crisis remain: There is no central authority to even coordinate national tax-and-spending policies.

In the past month, financial markets have turned their sights on Ireland and Portugal. Doubts remain over the solvency of banks on Europe's stricken fringe. That leaves them dependent on Mr. Trichet's largesse, in the form of "temporary" lending facilities introduced by the ECB when the crisis first hit.

Despite Mr. Trichet's assurances that the bond-buying program is a stop-gap, it not only continues but has also increased in recent weeks—with no end in sight.

—David Gauthier-Villars contributed to this article.

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