Greek Crisis Exacts The Cruelest Toll

BY MARCUS WALKER

HERAKLION, Greece—The first time he despaired of his debts, Vaggelis Petrakis drank a poisonous brew of beer and gasoline. A note he left didn’t mention the financial woes of his fruit and vegetable business, of which his family was well aware. Instead, he left instructions for his children on how to look after his animals. “Put mother rabbit in a different place from the little rabbits,” the note began.

Then he had second thoughts and called his son, Stelios, who took him to a hospital. Mr. Petrakis survived that suicide attempt. But Greece’s collapsing economy and the ruin of his business would soon push him to a more determined effort.

“It was shame, fear, pride, dignity,” says his son. “Whoever you ask, they will say he was a man of dignity.”

Two years into Greece’s debt crisis, its citizens are reeling from austerity measures imposed to prevent a government debt default that could cause havoc throughout Europe. The economic pain is the price Greece and Europe are paying to defend the euro, the centerpiece of 60 years of efforts to unite the Continent. But as Greece’s economy shrinks, its society is fraying, raising questions about how long Greeks will be able to take the strain.

Gross domestic product in the second quarter was down more than 7% from a year before, amid government spending cuts and tax increases that, combined, will add up to about 20% of GDP. Unemployment is over 16%. Crime, homelessness, emigration and personal bankruptcies are on the rise.

The most dramatic sign of Greece’s pain, however, is a surge in suicides.

Recorded suicides have roughly doubled since before the crisis to about six per 100,000 residents annually, according to the Greek health ministry and a charitable organization called Klimaka.

About 40% more Greeks killed themselves in the first five months of this year than in the same period last year, the health ministry says.

Others have attempted suicide. On Friday, Greek police said, a man in his 50s struggling with his debts was hospitalized after setting himself on fire outside a bank branch in the northern city of Thessaloniki.

Suicide has also risen in much of the rest of Europe since the financial crisis began, according to a recent study published in the British medical journal The Lancet, which said Greece is among the hardest hit.

While some countries have higher rates of recorded suicides, including the U.S. over 10 per 100,000, mental-health professionals here say Greece’s data greatly understates the incidence of suicide because it carries a strong stigma among Greeks. The Greek Orthodox Church forbids funeral services for suicides unless the deceased was mentally ill. Families often mask suicide deaths as accidents.

A suicide help line at Klimaka, the charitable group, used to get four to 10 calls a day, but “now there are days when we have up to 100,” says a psychologist there, Aris Violatzis.

The caller often fits a certain profile: male, age 35 to 60 and financially ruined. “He has also lost his core identity as a husband and provider, and he cannot be a man any more according to our cultural standards,” Mr. Violatzis says.

Herklion, commercial center of the island of Crete, has had a spate of such deaths.

Mr. Petrakis, the fruit and vegetable dealer, was just one of three recent suicides at a single wholesale food market on the edge of the city.

Victims once were typically adolescent males or old people facing severe illness, and in normal times suicide cases often involve a mixture of factors including mental illness, says local psychiatrist Eva Maria Tsapaki.

But the economic crisis has created a “new phenomenon of entrepreneurs with no prior history of mental illness who are found dead every other week,” she says. “It’s very unusual.”

Part of the explanation, some locals believe, lies in the nexus of a burst credit bubble and the Cretan male identity. They say the island’s history of rebellion against foreign occupiers, from Ottomans to Nazis, has entrenched a cultural ideal of male strength and pride.

“Our pride is as high as Psiloritis,” the island’s tallest mountain, says Yiannis Tsevabanas, a local lawyer. The culture breeds confident, extroverted and adventurous characters, he says, “but when pride is lost, it can also make you vulnerable.”

For Mr. Petrakis, a burly, muscled man of few words, a local custom of free-flowing, often informal lending kept his business afloat for years. But after Athens in late 2009 disclosed a budget deficit far worse than previously reported, touching off the Greek debt crisis, he found himself squeezed between banks that would no longer lend and customers that could no longer pay.

Mr. Petrakis grew up in a poor olive-growing community in the mountains of Crete. As a small boy, he walked from village to village selling loukoumi sweets, similar to Turkish delight, from a homemade wooden box.

“He always kept the last and best piece for me,” says Georgia Petrakis, who was growing up in the same rural district. “We were in love since we were children.”

When she was 18, they married and moved to town, Mr. Petrakis worked day and night selling livestock feed from a truck, and would fall asleep exhausted while cradling their infant son. He found a job working at the wholesale food market and began to save to buy his own store.

Finally, in 2000, when he was 47, he managed to combine his savings with a bank loan and launch his own wholesale food business. “We felt we had almost made it,” Mrs. Petrakis says.

Life was getting better. Greece adopted the euro. The economy thrived. The family sold produce to hotels and supermarkets. Mr. Petrakis bought some land in the mountains, where he keeps animals and likes to relax.

But the hotels and supermarket chains often paid late. They gave small suppliers such as Mr. Petrakis postdated checks that couldn’t be cashed until months later.

This practice had long existed in Greece, but it exploded when it became a credit-driven economy in the 1990s, says Constantine Michalos, president of the Athens Chamber of Commerce and Industry.

Small businesses had little choice but to accept payment this way. In doing so, they were in effect acting as banks, lending to their own customers for several months for no interest.

“This was a para-banking system of enormous size. It is one of the main reasons for the crisis,” Mr. Michalos says.

Small businesses struggled with cash shortages because they had to pay their overhead when due, but wait months for hard cash from customers. Mr. Petrakis managed the same way other small entrepreneurs did:

To get money quickly, he took his customers’ postdated checks to banks and sold them at a discount.

If he had a check for €1,000 that couldn’t be cashed for five months, a bank would give him €800 right away, then another €100 on the date the check be-
came cashable, his lawyer, Aggelos Zervos, says. The bank would keep the remaining €100.

Though this gave Mr. Petrakis the cash he needed, it ate into his revenue and margins. "Without realizing, we were slowly going bust," Mrs. Petrakis says.

Then, after Greece's debt bubble burst, these postdated checks started bouncing frequently, including checks written by Mr. Petrakis's customers.

Some were longstanding friends. One was a relative who owned a supermarket. When Mr. Petrakis asked the customers to pay up after their checks bounced, they refused or made him wait longer, often bluntly telling him it was his problem, Mrs. Petrakis says.

"People he thought were friends changed their behavior," she says. Her husband had always been "very correct," and was dismayed by constantly finding himself arguing with old business partners. "He became more and more withdrawn."

Through the years, Mr. Petrakis had taken out extra bank loans, bringing his total bank debt to around €600,000, or about $850,000.

Now he began falling behind on loan payments. Banks were threatening the family with forced sales of their assets, including their home.

In desperation, Mr. Petrakis turned to a harebrained scam. In spring 2010, he obtained a fake postdated check in the name of an Athens company with which he had no dealings. He tried to sell it to a bank at a discount in the usual way.

Mr. Petrakis knew the check would bounce when it matured in the fall, and the bank would come to him wanting its money back, but he hoped by then to have money to repay the bank, says his lawyer, Aggelos Zervos. "He knew this was not right. All he could gain this way was time," the lawyer says.

The bank spotted the fake and called the police, who arrested Mr. Petrakis and searched his house. There they found his father's old World War II rifle, a common memento here, and charged him with possession of an unlicensed gun as well as financial fraud.

"Vaggelis was so ashamed, he couldn't look me in the eye," his lawyer says.

He was freed pending trial. A local newspaper wrote about a "check forger," Mr. Petrakis wasn't named, but "word got around," Mrs. Petrakis says. "We felt ostracized."

It was in July of last year that her husband first tried to take his own life by swallowing gasoline. In the hospital, his wife told him, "I don't want you to do this ever again." He promised not to.

"We've been through so much; we're going to make it," she told him while lying in bed at night. He agreed.

On his first day back at the fruit and vegetable market, however, he got into a loud argument over money with an orange grower. The man called him a "crook," says a fellow grocery wholesaler who came to his defense.

"For Vaggelis to be called a crook here at the market was a big offense. I would have killed the guy," the fellow wholesaler says.

Mr. Petrakis turned pale, took his car keys and drove off. His wife ran behind the car, screaming for him to stay. His family searched for him throughout the day and night.

Mr. Petrakis collected his hunting rifle from home and wrote farewell notes over four pages of an old calendar. The banks had destroyed him, he wrote, and he had lost his honor over the check affair. He warned that others on Crete would suffer his fate.

"Please forgive me," he wrote. "I love you very much."

At 5 a.m., Mrs. Petrakis heard her husband's dog whimpering in an olive grove by the field where he kept his animals and used to go for peace of mind.

In the dark, she tripped over him beneath an olive tree. He was still alive but, with a gunshot wound in his head, could no longer speak. He died in her arms.
Dithering at the Top Turned EU Crisis to Global Threat

BY CHARLES FORELLE AND MARCUS WALKER

At a closed-door meeting in Washington on April 14, Europe’s effort to contain its debt crisis began to unravel.

Inside the French ambassador’s 19-bedroom mansion, finance ministers and central bankers from the world’s largest economies heard Dominique Strauss-Kahn, then-head of the International Monetary Fund, deliver an ultimatum.

Greece, the country that triggered the eurozone debt crisis, would need a much bigger bailout than planned, Mr. Strauss-Kahn said. Unless Europe coughed up extra cash, the IMF, which a year earlier had agreed to share the burden with European countries, wouldn’t release any more aid for Athens.

The warning prompted a split among the eurozone’s representatives over who should pay to save Greece from the biggest sovereign bankruptcy in history. European taxpayers alone? Or should the banks that had lent Greece too much during the global credit bubble also suffer?

The IMF didn’t mind how Europe proceeded, as long as there was clarity by summer. “We need a decision,” said Mr. Strauss-Kahn.

It was to be Europe’s fateful spring. A Wall Street Journal investigation, based on more than two dozen interviews with eurozone policy makers, revealed how the currency union floundered in indecision—failing to address either the immediate concerns of investors or the fundamental weaknesses undermining the euro. The consequence was that a crisis in a few small economies turned into a threat to the survival of Europe’s common currency and a menace to the global economy.

In April, after a year of drama and bailouts, the euro zone seemed to have contained the immediate crisis to Greece and other small countries. Crucially, eurozone economies such as Spain and Italy had avoided the panicked flight out of capital. “They were still able to borrow money at affordable rates in the bond market.

But by July, the rift among eurozone leaders over who should bear the burden of Greece’s debt had prompted investors to shun all financially fragile euro nations. Like a wildfire, the spreading uncertainty threatened to engulf the whole of Europe’s indebted south, to outstrip the resources of its richer north and to burn down the symbol of Europe’s dream of unity, its single currency.

Now, as the bloc’s leaders rush to forge a closer political union, the lesson of that period looms large. Investor trust in public debt is part of the foundation on which all nation-states depend. And in Europe’s common currency—a unique experiment with the livelihoods of 330 million people—nations will win or lose that trust together.

The dispute at the Washington meeting divided two of the Continent’s grand old men, both of them born in 1942 and both among the fathers of the euro.

Wolfgang Schäuble, Germany’s ascetic and irascible finance minister, understood the IMF’s ultimatum. The euro zone would have to draw up a second bailout package for Greece by summer, just a year after a loan deal for €110 billion, or $140 billion.

But this time, Mr. Schäuble said, “We cannot just buy out the private investors” with taxpayer money. That would reward reckless lending, he said, and it would never get through an increasingly impatient German parliament. Greece’s bondholders would be required to lend more money, Mr. Schäuble proposed, rather than take payment for their bonds at maturity.

Jean-Claude Trichet, the urbane French head of the European Central Bank, warned against forcing bondholders to put in more money, which would effectively delay repayment. “This is not a good way to go in a monetary union,” Mr. Trichet said. “Investors would avoid all euro-area bonds.”

Mr. Trichet, in the twilight of a 36-year career as a finance official, feared that if Greece didn’t honor its bond debts on time, the implicit trust that kept credit flowing to many weak eurozone governments would shatter. More countries and their banks would lose access to capital markets, in a chain reaction with incalculable consequences.

The April meeting ended inconclusively.

Meanwhile, the cost for fixing Greece was rising. The Athens government’s budget deficit was stuck at a stubbornly high level. Italian and Spanish borrowing costs were still affordable and stable. The yield on Spain’s 10-year bonds hovered around 5.3%; on Italy’s, around 4.6%.

The debate over making bondholders contribute to the new funding package for Greece—known as private-sector involvement, or PSI—divided eurozone countries.

Germany had allies. In the Netherlands and Finland, new governments had promised voters they wouldn’t pay for problems in less-frugal Mediterranean countries. Breaking those promises would risk rebellions in parliament.

But France joined the ECB in resisting burden-sharing by bondholders. France’s banks had lent more heavily than Germany’s to Greece and other indebted euro nations, and France fretted about a Lehman Brothers-style banking system meltdown. Italian officials also feared that a precedent for losses in Greece would scare investors away from Italy’s bonds.

Three weeks after the Washington gathering, on Friday, May 6, panic erupted. German news weekly Der Spiegel reported that Greece was thinking of leaving the euro zone, with policy makers heading to a secret meeting that night in Luxembourg.

The report was half-right. There was a meeting, but Greece was staying put.

Inside a country chateau, top eurozone officials told Greece’s finance minister they expected deeper austerity and faster reforms in return for a new aid package.

Then Mr. Schäuble said he wanted to discuss how bondholder burden-sharing would work. The usually smooth-handed Mr. Trichet lost his patience. “I want to put my position on the record,” he said: “I don’t agree with private-sector involvement, so I won’t take part in a discussion about the practicalities.” He stormed out.

Mr. Trichet’s assent was vital. If the ECB were to stop accepting Greek bonds as collateral for its lending to banks on the grounds
that the bonds were in default, then Greece’s banks, which were stuffed full of their government’s bonds, would quickly run out of cash and collapse. That would radically drive up the cost of a rescue.

In Greece, a new wave of mass strikes and demonstrations was starting. Protesters, angry about Europe’s imposition of extra spending cuts and tax hikes, clashed with police in front of the Athens parliament in the biggest and most violent protests in a year.

Spanish and Italian bond prices remained stable. But Europe was at a dangerous impasse over Greece.

Many euro-zone governments hoped Mr. Strauss-Kahn could find a way to relax the IMF’s summer deadline. The IMF chief was due to discuss the matter with German Chancellor Angela Merkel in Berlin on May 15, and with euro-zone finance ministers in Brussels the next day.

Mr. Strauss-Kahn couldn’t attend. Police in New York pulled him off his Paris-bound flight and charged him with sexually assaulting a hotel chambermaid. (The charges were later dropped, and prosecutors said they doubted the maid’s reliability.) An aide phoned Ms. Merkel at her central-Berlin home that Saturday and told her the news. The astonished chancellor responded with a German idiom that translates roughly as: “You couldn’t make this up.”

The IMF sent a lower-ranking official to Brussels in his place who had no latitude to deviate from the IMF’s deadline.

In Athens, meanwhile, a tide of the “Indignant” protest movement—a groundswell of anger at the country’s impoverishment—sprang up outside parliament. Spain’s bond prices began to wobble as investors worried that other countries might also face debt restructuring.

On June 1, Mr. Schäuble’s deputy, Jörg Asmussen, presented a German plan at a meeting of finance officials in Vienna, at the Hofburg palace of the former Habsburg emperors. It involved pressuring Greece’s bondholders to swap their Greek debt for new IOUs that would come due far in the future. That would cut the amount of European taxpayer funding Greece would need.

After a meal in a palace banquet hall, the officials quarreled into the wee hours.

For the ECB, Mr. Trichet’s deputy Vitor Constâncio, of Portugal, denounced the German plan as “dangerous.” Credit-rating agencies would declare Greece to be in default on some of its debts—a so-called selective default. In that case, Mr. Constâncio warned, the ECB would refuse to accept Greek government bonds as collateral, dealing a death blow to Greek banks. France, Italy and Spain all supported Mr. Constâncio.

Germany’s Mr. Asmussen shot back with a threat of his own. Europe needed Germany’s money to fund a new program of Greek loans. “Without private-sector involvement,” he said, “there will be no program.”

Greece was descending into chaos. Embattled premier George Papandreou’s slender majority in parliament was fraying. On June 15, a swelling demonstration in Athens’s central square veered out of control.

Alone in his office, Mr. Papandreou phoned the parliamentary opposition leader and offered to make way for a national-unity government. Talks broke down, and the Greek government limped on badly wounded. Even Ms. Merkel had some doubts about her finance minis-

try’s hard-line insistence that Greece’s bondholders take a loss.

On June 17, she discussed a softer plan with French President Nicolas Sarkozy: a gentleman’s agreement under which Greek bonds would be honored but the bondholders would volunteer to buy new ones.

Mr. Schäuble pushed back. The veteran conservative politician was Berlin’s biggest supporter of the European dream, but he was also the keeper of Germany’s purse. He was determined to make banks share the burden with German taxpayers, and he didn’t trust them to keep a gen-

The Crisis Cast | Money, power and politics entangle euro’s big players

Jean-Claude Trichet
ECB President
Euro father doggedly, even dogmatically, defended ECB’s independence, insisting the central bank shouldn’t be recruiting governments.

Nicolas Sarkozy
French President
Hyperkinetic leader strove to prove his crisis-solving bona fides, but France’s tenuous fiscal condition left him second chair to Merkel.

Angela Merkel
German Chancellor
Risk-averse leader came under growing global pressure to lead Europe out of the crisis.

Wolfgang Schäuble
German Finance Minister
Irascible political veteran and staunch believer in the euro insisted banks should help rescue Greece.

Silvio Berlusconi
Italian Prime Minister
Consumed by sex scandals and unable to push through reforms, the billionaire politician watched as Italy’s borrowing costs soared.

George Papandreou
Greek Prime Minister
Idealist politician wasn’t prepared for the scale of the Greek crisis he inherited, and he struggled to convince Greece to accept loss of entitlements.

Dominique Strauss-Kahn
IMF Managing Director
Brought the IMF to the crisis’s front lines, which dovetailed with ambition to be France’s president—until his sexual affairs took him down.

Christine Lagarde
IMF Managing Director
Proud and elegant, French finance minister took Strauss-Kahn’s job, then pushed governments to do more.
tlemen’s agreement.

When finance ministers met again on June 20, Mr. Schäuble pushed harder. Greece’s bondholders should be told not merely to accept a delay in repayment, he said, but also to forgive some Greek debt—a so-called haircut.

As Greece’s economy moved toward free fall, its debts were soaring beyond the country’s ability to pay, the Germans and their northern allies argued. Mr. Trichet and the southern countries resisted. Talks dragged on for hours. The ministers knew they couldn’t leave without some agreement.

They tried to please everyone: Greece would get more aid. Bondholder losses would be substantial, to placate the Germans, Dutch and Finns. But as the ECB insisted, they would avoid pushing Greece into selective default.

Investors knew you couldn’t have it both ways. As the threat of a Greek debt restructuring sank in, Southern Europe’s bond markets grew volatile. Spain’s 10-year bond yield rose above 5.6%. Italy’s reached 4.9%.

Greece’s parliament debated the extra austerity measures that Europe demanded. Central Athens erupted in violent protests. Anarchist youths tore up chunks of paving stone and threw them at riot police, who fired back with tear gas and stun grenades. Café parasols burned.

Europe hadn’t resolved how to keep Greece afloat. The IMF—whose demand for a decision had set off the whole argument—softened its ultimatum. IMF officials said they were satisfied that Europe would sort out some kind of new bailout, and wired Greece its summer aid payment on July 8.

It wasn’t enough to calm markets. Spain’s bond yield hit 6.3%. Italy’s rose to over 5.8%. Such borrowing costs, if sustained, would make it hard for both countries to rein in their debts.

The selloff in bond markets forced leaders to call an emergency summit for July 21.

Determined not to let the summit pass without an agreement, Ms. Merkel invited the French president, who objected to the German push for bondholder losses, to Berlin. The pair and their advisers met for dinner in the German chancellery the night before the meeting.

Few of them had time to touch the duck breast and vegetables on their plates as they searched for a compromise. Finally, Mr.
Sarkozy said he would accept the private-sector involvement—if Ms. Merkel dropped her resistance to giving the euro-zone bailout fund broad new powers to buy debt of weak countries directly and move to protect such countries as Spain and Italy from bond-market contagion. Ms. Merkel agreed.

One more person needed to sign off. Ms. Merkel phoned Mr. Trichet at his Frankfurt office. He took the last Lufthansa flight to Berlin and arrived at the chancellery around 10 p.m.

Reluctantly, Mr. Trichet gave his OK. But he set conditions. Governments would have to insure Greek bonds against default so that the ECB could continue to accept them as collateral. And they would have to make plain that no other euro country but Greece would have its debts restructured.

The trio’s deal was both complicated and vague. Their staffs had little time to flesh out details before the next day’s summit in Brussels. As leaders trickled into the European Union’s boxy headquarters, Ms. Merkel faced a challenge to placate the euro zone’s south, which thought private-sector involvement was dangerous, and its north, which thought it didn’t go far enough.

When the leaders assembled at the sprawling summit table, Ms. Merkel admitted that the specter of bondholder losses was causing market unrest. But, she said, some Greek debt relief was essential. Without it, the bailout’s tough austerity conditions—made tougher by Greece’s missing its budget goals—would be seen as unbearable.

“If Greece had met its program parameters in April,” she snapped, “that would have helped.”

All 17 euro nations had to agree to private-sector involvement. But presented with a calculation that the plan would reduce Greece’s debt by only about €19 billion out of more than €350 billion total, Dutch Prime Minister Mark Rutte balked. If it’s only €19 billion, he said, “I’m out. I need more.”

Finnish premier Jyrki Katainen also complained. His parliament wanted collateral in exchange for more Finnish lending to Greece. “No collateral, no agreement from me,” he said.

Mr. Sarkozy was peeved. “All our parliaments can cause problems,” he said.

Then it was Slovakia’s turn. Prime Minister Iveta Radčová was fighting to keep her coalition together over aid for Greece—a richer country than her own. Adding more powers to the bailout fund “would be suicide,” she said. Greece’s Mr. Papandreou pleaded for help. “If we can’t solve even Greece, we won’t be seen as being able to solve anything else,” she said.

Hours later, the leaders had a communiqué. To appease the holdouts, it left key points broad and noncommittal, offering the possibility of collateral to Finland and describing the complex bondholder deal in a few strokes, vague language that would return to haunt the bloc.

Officials struggled to explain the new Greek bailout and the bondholder losses. Amid the confusion, Mr. Rutte dispensed muddled numbers. Bank analysts put out flawed reports.

Investor confidence faltered as it became clear that Europe’s compromise achieved the worst of all worlds. Greece would be pushed into a historic default—the first time in nearly 60 years that a developed, Western country wouldn’t honor its debts. But the default was so small that Greece was still left with a crushing debt burden.

And then official Europe went on vacation: Ms. Merkel to the Italian Alps, Mr. Sarkozy to the French Riviera.

Bondholders didn’t. They went on a rampage.

—Stephen Fidler, David Gauthier-Villars, Sudeep Reddy and Brian Blackstone contributed to this article.
Deepening Crisis Over Euro Pits Leader Against Leader

By Marcus Walker in Berlin, Charles Forelle in Brussels and Stacy Melichry in Rome

BERLIN—On a chilly October evening in her austere chancery, Angela Merkel placed a confidential call to Rome to help save the euro.

Two years after the European debt crisis erupted in little Greece, the unthinkable had happened: Investors were fleeing the government debt of Italy—one of the world’s biggest economies. If the selloff couldn’t be stopped, Italy would go down, taking with it Europe’s shared currency.

Her phone call that night to the 16th-century Quirinale Palace, once a residence of popes, now home to Italy’s octogenarian head of state, President Giorgio Napolitano, trod on delicate ground for a German chancellor. Europe’s leaders have an unwritten rule not to intervene in one another’s domestic politics. But Ms. Merkel was gently prodding Italy to change its prime minister, if the incumbent—Silvio Berlusconi—couldn’t change Italy.

Details of Ms. Merkel’s diplomatic channel to Rome haven’t previously been reported.

Her impatience shows the extent to which Italy’s woes under Europe’s strategy to fight the crisis. Until then, Europe had followed a simple formula to preserve the euro: The financially strong would save the weak. But Italy, with nearly €2 trillion, or about $2.6 trillion, in national debt, was simply too big to save.

This Wall Street Journal re-construction, based on interviews with more than two dozen policy makers, including many leading actors, as well as examinations of key documents, reveals how Germany responded to the dangers in Italy by imposing its power on a divided euro zone. Ms. Merkel, widely criticized for not dealing forcefully with the crisis in its early phase, was at the center of the action, grappling with personal tensions and Byzantine politics among the 17 euro nations.

As well as nudging Mr. Berlusconi off the stage, Ms. Merkel had to smooth out her volatile relationship with France’s president, Nicolas Sarkozy. The Franco-German couple eventually overcame many of their differences—and Mr. Berlusconi—only to be blindsided by fresh political chaos in Greece.

Europe’s crisis is rooted in deep worries about government debt and economic imbalances inside the euro zone. Those concerns have scared bond investors away from Europe’s weaker states, leaving some, like Greece, without access to money with which to refinance or repay their debts. The great danger is that Italy might join them.

Greece and others were small enough to rescue with international bailouts. But an Italian default could severely hurt Europe’s, and the world’s, financial system, perhaps triggering a worse global slump than the 2008 failure of Lehman Brothers did.

The scramble to shore up investor confidence in Italy led to simmering arguments over how to pay for a financial safety net. Europe’s leaders were reluctantly realizing that living with a common currency meant surrendering more of their national independence than they had bargained for.

France and others urged drawing on the virtually unlimited firepower of the European Central Bank. But German structures and the central bank’s own reluctance to bail out governments—for fear of igniting inflation or rewarding profligacy—frustrated that idea.

And while German pressure helped bring about a new, reform-minded government in Italy, today Europe is still fighting to save the euro. The battle ahead looks daunting.

The euro zone, which accounts for nearly 20% of global economic activity, is sliding into recession. France and other countries are struggling to save their credit ratings. And Italy must borrow some €400 billion in 2012.

It’s far from clear whether investors are willing to loan such amounts. On Thursday, Italy sold €7 billion in bonds, less than the full amount it had targeted. Investors demanded a yield of nearly 7% on 10-year lending, a painfully high rate.

From the dawn of the crisis in late 2008, Europe’s leaders knew they had to avoid a bond-market run on Italy, given its big economy and towering pile of debt. But it was their own handling of Greece that helped spur just such a run.

A July 21 decision to restructure Greece’s bond debt, which saddled private investors with losses, set a precedent that made many investors wary of lending to any indebted euro members.

Italian politics unnerved the market further. Mr. Berlusconi fell out with his finance minister, Giulio Tremonti, considered a steady hand on Italy’s tiller.

“Tremonti thinks he’s a genius and everyone else is a cretin,” Mr. Berlusconi said in his office, adding that his finance chief was “not a team player,” according to a person familiar with the matter.

Rumors swirled that Mr. Tremonti might resign, pushing Italy’s borrowing costs to a euro-era high. That made it ever tougher for Italy to climb out of its financial hole.

When the market rout worsened on Aug. 3, Mr. Berlusconi gave a defiant speech before parliament declaring that his policies “have been judged adequate by Europe.”

Two days later, the ECB contradicted him in a secret letter. Italy’s deficit-cutting plan was “not sufficient,” ECB President Jean-Claude Trichet and his anointed successor, Mario Draghi, wrote to Mr. Berlusconi.

The letter said Italy needed extensive economic overhaul to boost growth, and it set out detailed demands including greater competition, labor-market deregulation, reduced pension largesse, a slimmer bureaucracy and deeper public spending cuts.

The implicit message: These reforms were the conditions for ECB intervention in the bond market.

But at was furious. Mr. Tremonti would later privately tell a group of European finance ministers that his government had received two threatening letters in August: one from a terrorist group, the other from the ECB. “The one from the ECB was worse,” he quipped.

Mr. Berlusconi gave in. On Sunday, Aug. 7, he faxed a letter to the ECB pledging far-reaching reforms and deeper budget cuts.

Mr. Trichet deemed Rome’s reply satisfactory, and the next day, the ECB for the first time began buying Italian bonds, calming investors and giving them renewed confidence to buy Italian debt themselves. Rome’s borrowing costs declined.

But at home in Italy, Mr. Berlusconi’s reforms faced political resistance. He wavered.

Messrs. Trichet and Draghi phoned to press Mr. Berlusconi to honor his promises. European Union President Herman Van Rompuy also called and asked him to take the crisis more seriously. “Otherwise,” Mr. Van Rompuy told him, “we are all in trouble.”

On Aug. 31, Italian media reported that Mr. Berlusconi had told his advisers he was giving up on pension reform, a key ECB demand.

Investors resumed their flight from Italy. The ECB let Italian bond yields rise again. The episode appeared to confirm the fears of the German faction at the ECB: Politicians would revert to bad behavior if given a reprieve from market pressures.

The crisis had reached a scale that matched the global economy. The ECB wasn’t going to save Italy. Europe’s other governments didn’t know where else to turn.

The rest of the world was running out of patience. The euro-zone bailout fund—already
committed to financing Greece, Ireland and Portugal—had only about €250 billion to spare. If Italy lost the ability to borrow in financial markets, it would burn through that amount in just a few months.

At September's annual meeting of the International Monetary Fund in Washington, D.C., Europe faced intense pressure to act. China and Brazil joined the U.S. in berating Europe for its too-small war chest. Europe was told to “leverage” its bailout fund by borrowing hundreds of billions of euros from the ECB.

Jens Weidmann of Germany’s central bank quashed that idea. The bailout fund was an arm of the governments, he said, and lending to governments was against the ECB’s charter.

The only options remaining were complicated schemes to offer investors in Italian bonds partial protection through guarantees or a “special-purpose investment vehicle.” The problem, officials privately admitted, was that this amounted to financial gymnastics of the kind that banks had indulged in before the 2007 mortgage crash.

On Oct. 19, Mr. Sarkozy sought to break the deadlock. Leaving his wife, the singer and former supermodel Carla Bruni-Sarkozy, in labor at a Paris clinic, he flew to Frankfurt to confront Mr. Trichet over the ECB’s reluctance to take bolder action.

Official Europe was gathering at Frankfurt’s stately Alte Oper concert hall for a party to honor Mr. Trichet’s retirement as ECB head. Mr. Sarkozy hadn’t come to celebrate. While the orchestra played Rossini and Mozart, a clique of Europe’s most powerful leaders huddled in a side room.

Mr. Sarkozy insisted that only decisive ECB help in government bond markets could save the euro zone. “Everything else is too small,” Mr. Sarkozy said. Strains of the “Barber of Seville” overture reached the brown-paneled meeting room.

Mr. Trichet said it isn’t the ECB’s job to finance governments. His farewell party began turning into a shouting match in French.

Already, he said, the central bank’s limited bond-buying had caused a political backlash in Germany, the euro’s most powerful nation. “I did not try, and I was massively criticized in Germany,” Mr. Trichet said.

Ms. Merkel, also present, was irritated by the French pressure on the ECB. She thought Mr. Sarkozy, with whom she had a sometimes prickly relationship, was well aware that Germany opposed using the central bank’s money-printing press to tackle the crisis.

Ms. Merkel came to Mr. Trichet’s defense, “You’re a friend of Germany,” she said.

News came from Paris that Mr. Sarkozy’s wife had given birth to a girl. Ms. Merkel offered restrained congratulations to France’s president. The meeting ended without agreement.

A day later, Ms. Merkel made her confidential phone call to Rome. Behind the move was a growing belief in Berlin that euro-zone nations could no longer afford to live however they pleased. Italy’s premier, Mr. Berlusconi, mired in legal and sexual scandals and unabashed about his reputation as a libertine, was the temperamental opposite of the sober Ms. Merkel, the daughter of a Lutheran pastor.

Mr. Berlusconi’s failure to reanimate Italy’s economy endangered Europe. So Ms. Merkel phoned Mr. Napolitano—as Italy’s president, the man with authority to name a new prime minister if the incumbent were to lose parliament’s support.

Ms. Merkel told the 86-year-old president that Italy’s deficit-cutting efforts were “appreciated,” but that Europe really wanted to see more aggressive reforms to boost economic growth. She said she was worried Mr. Berlusconi wasn’t strong enough to deliver.

Mr. Napolitano said it was
“not reassuring” that Mr. Berlusconi had recently survived a parliamentary vote of confidence by just one vote.

Ms. Merkel thanked the president in advance for doing what is “within your powers” to promote reform.

Mr. Napolitano got the message. Days later, he quietly began sounding out Italy’s political parties to test the support for a new government if Mr. Berlusconi couldn’t satisfy Europe and the markets.

Europe had promised the world it would fix its problems by late October. But Italy was only one of its headaches. While Rome struggled, Greece defied attempts at repair. The Greek bailout deal signed in July now looked far too small. Greece’s economy was coming apart.

On Oct. 21, inspectors from the EU and IMF said Greece would now need more than €140 billion in extra-euro-zone taxpayer aid through 2020, unless private-sector bondholders forgave 60% of what Greece owed them.

Germany pressed for a deep restructuring of Greek debt. France, fearful that rising bailout costs could jeopardize its own triple-A credit rating, dropped its objections.

Ms. Merkel repaired relations with Mr. Sarkozy at an EU summit on Oct. 23. She gave him a German teddy bear for his baby daughter. The president phoned his wife, Ms. Bruni-Sarkozy, and passed the cellphone to Ms. Merkel, who congratulated France’s first lady.

The debate over Greece deepened. The Institute for International Finance, a banking lobby representing many of Greece’s biggest creditors, resisted large-scale debt forgiveness for Athens. The banks wanted to make a smaller sacrifice.

Ms. Merkel, on the other hand, wanted banks to forgo 50% of their Greek bond repayments, up from an average 10% under the July accord. Governments would guarantee part of what remained.

Early in Brussels on Oct. 27, at a meeting past midnight, Ms. Merkel and Mr. Sarkozy summoned IIF head Charles Dallara into a room at EU headquarters. “This is the last offer,” Ms. Merkel said, handing Mr. Dallara a draft agreement that included the 50% demand.
Her unspoken threat: Banks might get nothing if they spurned it.

Mr. Dallara left the room to phone top bankers. The IIF accepted the deal, and investors expressed relief that Greece wasn’t pushed into a full default. Italian bond yields paused their upward march.

But the calm didn’t last. Late on Oct. 31, Greek Prime Minister George Papandreou threw a wrench into the works by saying he would call a referendum on the bailout.

Europe was horrified. A “no” vote would sink the bailout and push Greece into the biggest sovereign bankruptcy in history.

Bond markets tanked. Eurozone leaders summoned Mr. Papandreou to Cannes, France, on Nov. 2, ahead of the Group of 20 summit of world leaders.

Penetrating rain dulled the Riviera resort, which in fairer months welcomes movie stars and oligarchs with a palette of sparkling azure. “The real question” for the referendum, Ms. Merkel told Mr. Papandreou there, “is ‘Do you want to be in the euro, or not?’”

A taboo had been broken. For the first time, Europe’s leaders were openly suggesting that the euro’s weakest members could be cast out.

In Cannes, Spanish Finance Minister Elena Salgado made a bet with her German counterpart, Wolfgang Schäuble, that there would be no Greek referendum. She won the wager, and a bottle of fine wine.

In the end, Mr. Papandreou’s own party colleagues rebelled against his idea for a plebiscite. He was forced out of office. The Greek bailout remained in place.

The Cannes conclave turned to Mr. Berlusconi. Italy, Europe’s leaders told him, was close to being shut out of bond markets. During lengthy discussions, Mr. Berlusconi fell asleep until aides nudged him awake.

Just days earlier, Mr. Napolitano had released a cryptic statement. He considered it his duty, he said, “to verify the conditions” of Italy’s “social and political forces.” It was code for speaking more openly with parliament’s main groups about forming a new Italian government.

On Nov. 8, Mr. Berlusconi, a dominant figure in Italian politics for 17 years, lost his parliamentary majority. Soon he resigned. Mr. Napolitano, with broad assent in parliament, named the respected economist Mario Monti as Italy’s new premier.

As 2011 drew to a close, Ms. Merkel’s pressure had helped to install the reform-oriented leaders in southern Europe that she wanted, albeit ones that voters hadn’t elected. She and Mr. Sarkozy have also steered the euro zone as a whole toward German-style fiscal rigor aimed at balancing budgets and cutting public debt.

But while Germany touts pan-European austerity as the key to stabilizing the region, investors remain doubtful. Italy’s bond yields are still at a worryingly high level. And Europe is still looking for money.

—Brian Blackstone in Frankfurt, David Gauthier-Villars in Paris and Stephen Fidler in Brussels contributed to this article.
Crisis Ensnare Central Bank In Desperate Bid to Save Euro

BY BRIAN BLACKSTONE
AND MATTHEW KARNITSCHING

FRANKFURT—At a mid-July meeting of the European Central Bank’s governing board, the bank’s longtime president, Jean-Claude Trichet, was summoned from a conference room to take an urgent call from Berlin.

It was Angela Merkel. The German chancellor and French President Nicolas Sarkozy were about to meet in Berlin to deal with Greece’s debt crisis and were at odds over what losses investors might be forced to take. They hoped the ECB could broker a compromise.

“They want me to go to Berlin,” Mr. Trichet told ECB colleagues when he returned from taking the call. He demurred, worried about thrusting the central bank deeper into the political realm and risking its independence.

In the end, however, Mr. Trichet and his central-bank colleagues reached a conclusion that has defined their approach to the two-year-old crisis that has gripped the euro-zone: The danger of not helping outweighed the risk of entering the political fray.

Mr. Trichet caught the last Lufthansa flight to Berlin and passed through the gates of the austere chancellery, where he stayed past midnight in Ms. Merkel’s office helping put together a deal on a new Greek bailout plan that was unveiled the next day.

Europe’s politicians, unable to end the euro zone’s debt crisis, have relied increasingly on the ECB, an institution that was chartered to foster price stability but instead finds itself propping up the borrowing power of fragile nations.

The expansion of its mission has profound consequences for Europe because in transcending its mandate, the ECB has assumed a new role: Europe’s most potent institution.

As the future of the euro hangs in the balance, many now believe the central bank is the euro’s only hope for survival.

The worsening of the crisis in recent weeks has prompted calls from some European leaders, as well as senior U.S. officials, for the ECB to become more assertive. Federal Reserve Chairman Ben Bernanke, worried about the threat Europe poses to the U.S. economy, pressed Mr. Trichet recently to cut a deal with politicians to resolve the crisis by substantially boosting the firepower of Europe’s bailout fund.

The gathering storm in Italy has a growing number of policy makers calling on the ECB to use its most powerful tool—its printing press—to shore up debt markets by buying unlimited amounts of euro-zone bonds, becoming the lender of last resort.

So far, the bank has resisted, arguing this wouldn’t be legal under European law. Yet few believe the ECB would let the common currency collapse to defend that principle.

That the bank has been forced to step into the power vacuum left by a fractious political class underscores the increasing centrifugal forces unleashed by the debt crisis.

A decade of growth across much of Europe initially followed the 1999 introduction of the euro, seeming to vindicate the promise that closer European integration would bring prosperity. The debt crisis that began in Greece two years ago has upended that idea, bringing the Continent’s divisions to the fore.

Germany, Europe’s largest and most prosperous country, is insisting that profligate countries implement deep cuts to public spending in return for aid, and refusing to endorse a broader role for the ECB. Germany’s orthodoxy has isolated it within Europe and on the ECB’s governing council. Many European leaders worry that national resentments could boil over if the crisis persists, destroying not just the euro but the EU itself.

Three camps have emerged within the ECB itself. One, led by Germany, is firmly opposed to more aggressive bond purchases, saying the program blurs the line between fiscal and monetary policy. Another, led by the euro zone’s southern flank, sees the ECB as the only functioning institution against the crisis and one that should do whatever it takes to support markets. A pragmatic third camp, including countries such as Austria and Finland, has been willing to go along with limited bond purchases but is losing patience.

It will largely be up to Mario Draghi, who succeeded Mr. Trichet as ECB president this month, to decide which course to embrace. It is an awkward position for the Italian to have his first major decision be whether to bail out his home country, after the ECB failed to respond aggressively when others, such as Ireland and Portugal, were in the market’s cross hairs.

“One scenario is the crisis gets to a point where they become a big central bank” that is willing to do whatever is necessary to maintain financial stability, says Paul De Grauwe, a European economist who thinks the ECB has been too timid in fighting the crisis. “The other scenario is dogmatism prevails, and the whole thing collapses.”

The ECB’s influence was on full display in Italy last week. When Italy’s cost of borrowing spiked to levels considered unsustainable, the central bank did almost nothing.

Instead of stepping into the market and aggressively buying Italian bonds to push yields back down, as it had done previously, it sat on its hands. Within days, Silvio Berlusconi’s Italian gov-
The bank's inaction led to suggestions it was playing the role of kingmaker. Members of the bank's governing council had grown impatient with the progress of reform in Italy. ECB officials in August thought they had an iron-clad commitment from Italy to take tough austerity measures; when Mr. Berlusconi started to backtrack, ECB officials felt they had been misled.

On Saturday, the day Mr. Berlusconi drove past hecklers to hand his resignation to the Italian president, Mr. Draghi was also in Rome. The new ECB president paid a visit that day to Mario Monti, then considered the leading candidate to replace Mr. Berlusconi. The appointment was viewed by many in Europe as a tacit signal that the ECB president endorsed Mr. Monti as prime minister. Mr. Monti was named to the position earlier this week.

The turmoil surrounding the ECB is in contrast to the calm that marked its first decade. Established in 1998, the ECB was founded on a German principle that strictly separates central bankers from governments, a principle rooted in Germany's own history. In the early 1920s, its Reichsbank bought massive amounts of government bonds to pay for printing money.

The result was hyperinflation, an episode that scars Germany's psyche as much as the Depression does in the U.S. The Reichsbank's successor, the Bundesbank, safeguarded Germany's postwar recovery by focusing on a single mandate to keep inflation low, a duty enshrined in the ECB's charter.

Its first president, Dutchman Wim Duisenberg, was so grounded in the tradition of central-bank independence that he was known to tell politicians "I hear you, but I don't listen."

Under Mr. Duisenberg and in the early years of Mr. Trichet's presidency, conducting monetary policy was fairly routine. Officials looked at inflation indicators, growth in the money supply and wage negotiations by large German unions, and set official interest rates accordingly.

Aided by a favorable global economy, Mr. Trichet didn't raise interest rates his first two years, and then did so at a gradual pace to keep inflation in check. Behind the scenes, he was under constant pressure from some member states to more aggressively support the euro-zone economy, calls he ignored.

But as the ECB spurned advice from Europe's capitals, governments returned the favor in fiscal policy, running up large deficits and weakening the euro bloc's budget rules, over Mr. Trichet's objections. "We are dancing on a volcano," he more than once told his ECB colleagues, referring to the risks governments were taking.

Then came the collapse of Lehman Brothers in 2008 and, more critically for the ECB, Greece's debt crisis in late 2009. The latter exposed a fundamental flaw in the setup of the euro: a common currency and central bank without political union.

With no one else to step into the breach, the ECB tossed its rule book aside. Officials propped up banks by providing...
unlimited loans at low interest rates and by buying tens of billions of euros worth of collateralized bank bonds. As Greece, Ireland and Portugal careened toward default in 2010 and 2011, the ECB found itself as the only institution in Europe that could act quickly, by creating euros to buy bonds.

Proponents of a broader ECB role say Europe’s politicians lack the means to cope with a crisis of this severity even if they could overcome their differences. They contend the only way to forestall a collapse of the euro is for the central bank to declare that it will underpin the bond markets of all euro-zone governments.

Germany’s worry is that such a move would spark a debilitating inflationary spiral. Germans’ visceral rejection to printing money is so strong that endorsing such a course could amount to political suicide for Ms. Merkel and her coalition.

The frictions burst into the open on Wednesday when German Finance Minister Wolfgang Schäuble shot down a call from visiting Irish Prime Minister Enda Kenny’s for the ECB to adopt the expansive powers enjoyed by the Federal Reserve. “A U.S. Federal Reserve model will not work” in the euro zone, Mr. Schäuble said.

“The ECB should be the ultimate fireproof,” Mr. Kenny retorted as Mr. Schäuble locked on, shaking his head. “I know the chancellor disagrees with this,” Mr. Kenny said, “but what we’ve been concerned about is contagion.”

ECB bond buying so far hasn’t stemmed the debt crisis because the bank makes clear its interventions are limited and temporary, critics say. “They need to go into the market and say we have a wall of money here and no matter how much speculation there is, we are going to keep buying Italian bonds and any other euro bonds that are threatened,” Irish Finance Minister Michael Noonan has said.

That would mark a dramatic departure from the central bank’s charter, which restricts its role to maintaining price stability through monetary policy, the setting of interest rates.

The euro zone’s architects purposely limited the ECB’s purview to shield it from political influence. Independence, they believed, would instill confidence in the long-term viability of the common currency, convincing both investors and ordinary Europeans that the bank’s power to create money wouldn’t be used to remedy political folly.

By testing the limits of its charter, the ECB has opened itself to accusations that it has traded principle for expediency, inviting disaster. Within the ECB, opponents of further action argue that the moves have already put the central bank’s reputation at risk. Such concerns prompted two prominent German members of the ECB’s governing council to resign in protest this year.

Others warn that the bond purchases could invite reckless fiscal behavior by governments, a phenomenon often referred to as “moral hazard.”

The credibility issue is central for skeptics of ECB bond buying. If the ECB were to give in to government demands for more aggressive action, the German public could lose confidence in the euro as a stable currency.

German economists contend that since the ECB prints the money to buy bonds, the extra funds it injects into financial markets when it makes bond purchases threaten to increase inflation. European inflation is currently about 3%, versus the ECB’s 2% target.

ECB officials say they aren’t adding new euros to the economy and feeding inflation because as they buy bonds, they withdraw equal amounts from the banking system. But if the ECB were to embark on unlimited bond buying, the sums involved would be too vast to withdraw.

In all, the ECB has bought nearly €190 billion in government bonds of fragile euro-zone countries. It also lends hundreds of billions of euros to commercial banks that are unable to borrow from other banks.

These actions have raised by nearly 80% the amount of assets on the ECB’s balance sheet since the start of the global financial crisis in 2008, though that’s well below the roughly 200% increase in the Fed’s balance sheet over that period.

There’s little evidence the ECB bond purchases so far have worked.

Greece remains at risk of default even after €50 billion in ECB purchases of its debt. In Italy, which doesn’t face the solvency issues confronted by Greece, the yield on 10-year bonds is back up near the 7% mark, well above the 6% yield that sparked ECB bond buying three months ago, despite an estimated €80 billion in central-bank purchases of Italian bonds since then.

If the bank were to ramp up its bond purchases aggressively and yet fail to calm markets, the damage to its credibility could be devastating.

Central banking is a subtle art that rests largely on the institution’s ability to convey an aura of invincibility. Once investors lose confidence in a central bank’s power, the credibility of the currency itself is impaired.

Other big central banks, particularly the Fed, have interpreted their mandates more broadly to preserve financial stability. The Fed, which unlike the ECB also has a mandate to maximize employment, has purchased large amounts of Treasury bonds to keep long-term interest rates low and has bought mortgage-backed securities to help housing.

Now, the ECB bank must decide if it needs to stray even farther from its core mission in to save the euro.

Mr. Trichet’s departure from the ECB offered a fitting coda to a tenure in which he largely succeeded in maintaining its autonomy. A farewell party for him last month in Frankfurt was interrupted by an emergency meeting, attended by Mr. Sarkozy and Ms. Merkel, to address the crisis. “These are difficult times,” Mr. Trichet said at his final press conference as president. “We all have to be up to the challenge.”

—Mary M. Lane

contributed to this article.
Struggling French Banks Fought to Avoid Oversight

BY DAVID ENRICH
AND DAVID GAUTHIER-VILLARS

PARIS—Two years ago, a French banker flew to Washington on an emergency mission: Persuade International Monetary Fund chief Dominique Strauss-Kahn that his concerns about the health of the European banking sector were unfounded.

The trip was a success. Mr. Strauss-Kahn agreed to keep his fears under wraps to avoid causing market panic, according to people familiar with the matter.

Today, that appears to have been a missed opportunity—one of many in the years leading up to Europe’s current banking woes. This summer, France’s three leading banks—BNP Paribas SA, Société Générale SA, and Crédit Agricole SA—became the focal point of a crisis of confidence that is engulfing European lenders and testing the political and economic underpinnings of Europe. On Thursday, a European push to produce a comprehensive plan to resolve the euro-zone debt crisis was in danger of unraveling amid disagreements between France and Germany.

Among the factors behind today’s crisis, experts say, has been the persistent unwillingness of many European banks and their regulators to acknowledge that they had a problem. Instead of making painful decisions years ago to set aside more money to cover unexpected losses, some of Europe’s leading banks and supervisors devoted themselves to fending off tougher international rules and thwarting more-intensive supervision.

Many large banks around the world lobbied aggressively against tough new rules. But the French banks and regulators were at the vanguard, mounting an aggressive campaign of résistance.

They hopscotched the globe petitioning against onerous banking rules. French banks often helped authorities devise key policies—in contrast to countries like the U.S., U.K., Switzerland and Spain that forced banks to raise tens of billions in new capital and to restructure. Sometimes, French bankers and government officials appeared to be reading from the same script.

French officials scooped at investors who worried that Greece and other euro-zone countries might default on their debt, heavily held by French banks. In April 2010, Bank of France Governor Christian Noyer argued against excessive capital cushions and insisted that French banks’ exposures to Greece were not a cause of “particular concern.” By the end of last year, France’s top four banks were sitting on a total of €415 billion (about $580 billion) in loans and debt from Greece, Ireland, Italy, Portugal and Spain, according to data gathered in a recent “stress test” of European banks. By comparison, Germany and Britain’s top banks were less exposed.

Now the bill is coming due. European political leaders plan in coming days to require European banks to come up with roughly €100 billion in new capital in coming months.

France’s major banks aren’t at risk of collapsing. But experts say their belated efforts to fortify their balance sheets could drag on the already sluggish French economy—the euro zone’s second-largest behind Germany.

Already, BNP, Société Générale and Crédit Agricole are reinventing in lending to some borrowers in order to improve their capital metrics. If those efforts prove insufficient, the French government could face a painful choice. It could inject taxpayer funds into the banks, which would strain the government’s finances and potentially jeopardize its triple-A credit rating. Or it could push the banks to further curtail lending, which would risk strangling the economy.

“French banks failed to learn lessons from the 2007, 2008 crisis and became complacent,” said Jézabel Coupey-Soubyran, an economics professor at the Panthéon-Sorbonne University in Paris. “They refused to put on a lightweight when the weather was still nice; now that climate is ice-cold, it’s not even sure that a heavy jacket will suffice.”

Investors said they worry the French banks lack enough capital to absorb mounting loan losses and potential government defaults. They fear the banks remain heavily reliant on the sort of short-term funds that tend to evaporate in a crisis. More than 70% of the market funding of BNP and Société Générale matures within a year, making them among the industry’s most vulnerable to investor flight, according to a recent report by Barclays Capital.

The banks insist their balance sheets are clean and they need no help.

BNP Paribas says it has increased its capital reserves to €57 billion, from €29 billion three years ago. Société Générale notes that it has limited exposure to southern Europe and says it has sliced its reliance on short-term funding by 16% since 2007, while boosting deposits and long-term financing. Crédit Agricole says it has also trimmed its reliance on short-term financing.

The three banks say they are on track to comply with tougher financial-health rules by 2013. The Bank of France said capital ratios are only one among many tools to keep banks in check. “We focus on intrusive controls and rigorous risk management,” a spokeswoman for the French central bank said.

The French banks and regulators began their resistance to new rules almost immediately once the global financial crisis kicked into gear in 2007 and 2008. They blamed the U.S., insisted that French banks were strong and repelled suggestions that the banks should beef up capital reserves.

Such a move would amount to “stocking up shareholders’ capital in the freezer,” BNP Paribas Chief Executive Baudouin Prot said in November 2008. Mr. Prot said his main strategy to keep his bank safe was to carefully select borrowers.

In late 2008 and early 2009, French banks did take a total of €20 billion in government loans to boost their capital reserves. But most of the money was repaid within a year.

Then a new cause for concern emerged: Greece. The small nation of 11 million, about 3% of the European Union total, acknowledged that it had underestimated its budget deficit and called on other Europeans and the IMF to the rescue.

In the fall of 2009, IMF technocrats started to wonder what would happen if Greece defaulted on its €350 billion debt and other European nations faced hardship. While Mr. Strauss-Kahn agreed not to go public with those concerns, he began using private meetings with European leaders to alert them about the problem. A spokeswoman for Mr. Strauss-Kahn declined to comment.

Following the flurry of bank implosions in 2008 and early 2009, international regulators started working on an overhaul of the global rules governing how much capital and liquidity banks are required to hold.

By the fall of 2009, the Basel Committee on Banking Supervision, named for the Swiss city in which it is based, had hashed out a tentative plan. It called for banks to hold far more capital than before. The types of capital that would count would be much more limited, ruling out certain types of securities and organiza-
A Long-Running Battle
French banks and regulators waged an extensive campaign to fend off tough rules and other actions. Chart shows CAC index of French bank and financial stocks.

Source: WSJ reporting; FactSet Research Systems (CAC Index)

In September 2010, the Basel Committee unveiled its final package. The tough new capital and liquidity requirements were mostly intact. But in a major concession to the industry, the rules would only fully take effect near the end of the decade.

Some U.S. regulators and outside critics warned that allowing so much time meant banks could be vulnerable if another crisis popped up in the meantime. As it turned out, one wasn’t far away.

By the beginning of 2011, many investors were growing panic. After maintaining for months that Greece wouldn’t be allowed to default on its debts, euro-zone governments changed tack, saying that private bondholders would have to help shoulder a new bailout for Athens by taking losses on their investments.

Investors immediately started to wonder what would happen if much bigger countries, such as Spain or Italy, couldn’t pay their debts. Among the casualties would be banks like France’s, which were holding billions of euros worth of government bonds, traditional safe investments that suddenly seemed risky. Investors feared losses on those investments could exhaust banks’ capital buffers.

French bankers and regulators dismissed such fears as “irrational.” They said that even if banks stored mountains of capital, it wouldn’t do much to insulate them from a major European country defaulting. French bankers, government officials and central bankers all made the same argument: “If a big country goes down, we all go down.”

Hoping to defuse public fears about banks’ solvency, European policymakers started designing a “stress test” of top banks.

At one of the first meetings of the newly created European Banking Authority, however, negotiators from France, together with Germany, argued the results shouldn’t be made public, according to people familiar with the matter. They were ultimately outvoted.

The biggest battle surrounded whether the tests should examine how banks would fare if struggling euro-zone countries defaulted on their debts.

French negotiators, along with German and European Central Bank officials, insisted that the tests not contemplate such a scenario, these people said. Sitting around a large oval table in an EBA conference room with panoramic views of central London, they argued that it could undermine already fragile confidence in the continent’s financial system.

Regulators from other coun-

Who’s on the Hook
French banks’ total exposures to Greece, Ireland, Italy, Portugal and Spain

<table>
<thead>
<tr>
<th>Bank</th>
<th>Total Exposure</th>
</tr>
</thead>
<tbody>
<tr>
<td>BNP Paribas</td>
<td>€198 billion</td>
</tr>
<tr>
<td>Crédit Agricole</td>
<td>€136 million</td>
</tr>
<tr>
<td>Société Générale</td>
<td>€47 million</td>
</tr>
<tr>
<td>BPCE</td>
<td>€38 million</td>
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</tbody>
</table>

Note: Data as of Dec. 31, 2010

 predatory structures that were popular with French banks, among others.

The proposal ignited a firestorm of criticism from banks. The French lenders, backed up by their regulators, were loudest in their protests, according to regulators and industry officials who took part in the discussions.

“Excessive capital and liquidity requirements would bring the economic recovery to a screeching halt,” the French Banking Federation wrote in spring 2010 on behalf of the CEOs of France’s five biggest banks.

Mr. Prot, the BNP CEO, took to privately badmouthing the Basel Committee’s chairman, Nout Wellink, then governor of the Dutch central bank. Mr. Prot questioned whether Mr. Wellink had the credibility to be crafting international banking regulations given the ills of some Dutch lenders.

Such a remark by Mr. Prot “would disqualify him as a prudent banker,” Mr. Wellink said in an email.

He also said, “French banks indeed resisted higher capital requirements and were very much against” a proposed liquidity rule.

BNP said it lobbied against higher capital surcharges but simultaneously boosted its reserves. “We did both: try to get a better deal and prepare ourselves for something we knew was in the works,” a BNP spokesman said.

In spring 2010, a regular quarterly meeting in Basel escalated into a heated debate. The Bank of France’s representative warned that banks would have to raise trillions in new funds, potentially choking off lending at a time of economic uncertainty, according to people who were there.

A British official retorted that even if France’s argument was true, it only underscored the need for the French banks to do more to improve their capital and liquidity, according to someone at the meeting.

French negotiators insisted that the committee commission a fresh “impact study” to assess any economic and financial fallout from the proposed rules, people familiar with the matter said. That led to a recommendation that the rules be phased in gradually—in line with the French banks’ demands.
tries disagreed. “The tests will be worthless” if they don’t consider the possibility of a sovereign default, one regulator fumed, according to someone at the meeting.

France and Germany prevailed. When the results were announced in mid-July, only a handful of banks failed, with a total shortfall of €2.5 billion in capital. All the French banks easily passed. Investors and analysts greeted the tests with skepticism.

In late August, nearly two years after the French banker’s mission to IMF headquarters, the agency delivered a stark warning.

European banks “need urgent recapitalization,” said the IMF’s new managing director Christine Lagarde. “This is key to cutting the chains of contagion.”

The message from Ms. Lagarde, who in her previous job as French finance minister had played down such concerns, spooked investors. Mr. Noyer, the Bank of France governor, replied that he didn’t understand what Ms. Lagarde meant. “Perhaps she was very badly informed by her staff,” he told French radio.

French banks found themselves increasingly locked out of short-term financing markets. Their stock prices plunged.

Yet the banks remained defiant. “I don’t see a big problem in terms of capital,” Société Générale CEO Frédéric Oudéa said at a New York conference on Sept. 13, after the bank’s shares had sunk 23% in the prior two weeks.

Weeks later, Franco-Belgian lender Dexia SA, which had breezed through the stress tests, required a government bailout.

In mid-September, Mr. Strauss-Kahn went on prime-time television in France, offering his first version of the New York sex scandal that cost him his job at the IMF. Turning to financial matters, he said European governments and banks could no longer delay solving the sovereign-debt crisis.

“The problem with Europeans,” he said, “is that they often act either too little or too late, or too little and too late.”