Sliding toward financial crisis

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By Stella Dawson, U.S. Economics Editor

WASHINGTON (Reuters) - Three years after the collapse of Lehman Brothers, the world's financial system is sliding toward another major crisis.

At stake is the global recovery and future shape of Europe.

Calls are mounting for financial leaders of the world's biggest economies meeting this week to take bold action, not on the scale of the $1 trillion rescue package of March 2009 but something equally important in policy terms.

The challenge for the Group of 20 talks in Washington on Thursday and Friday is to prevent a sovereign debt crisis centered in Greece from turning into a full-blown banking crisis. Such a crisis could engulf other indebted European countries, lead to messy defaults and plunge the region and world back into economic and financial turmoil.

"We have entered a dangerous new phase of the crisis," said Christine Lagarde, managing director of the International Monetary Fund, last Thursday. "To navigate it, we need strong political will across the world -- leadership over brinkmanship."

World Bank President Robert Zoellick a day earlier said: "The time for muddling through is over."

Pieces of a multipronged approach to the crisis have come into focus and should solidify further this week.

The political hurdles remain significant but if the parts of the program are endorsed by G20 finance ministers and central bankers, and their governments continue to deliver, investment strategists say turmoil in markets should abate.

Two factors are driving the crisis -- political discord within Europe over how much support to give indebted euro-zone governments that are implementing tough fiscal austerity programs; and vulnerabilities within the region's financial system, especially in France where banks hold 671.6 billion euros of government debt of high-deficit euro-zone countries.

These factors have fed upon each other in a vicious cycle. Talk among top German officials of Greece defaulting or leaving the euro zone has accelerated investor withdrawal of short-term funding to French banks, raising concerns about bank solvency.

To halt the cycle, the following steps are coming together:

* To support growth and ease lending costs, a growing number of central banks worldwide are loosening monetary conditions -- an action likely to win the G20's endorsement for countries where inflationary pressures are in check.

The Federal Reserve will play its part on Wednesday when it is expected to announce a plan to lower longer-term interest rates by shifting the balance of its $2.8 trillion securities portfolio away from short-term debt. How aggressively it does this, and whether it also cuts the interest rate paid to banks on their excess reserves held at the Fed, an idea gaining traction in markets, will signal the Fed's degree of concern over the economic slowdown.

* To address concerns about the ability of governments to service their debt, European finance ministers are considering proposals to leverage their 440 billion-euro European Financial Stability Fund, which should be up and running by month's end. The United States has suggested increasing the EFSF firepower roughly ten-fold to give it the capacity to handle a sovereign bailout the size of Italy or help recapitalize banks.

Treasury Secretary Timothy Geithner got a cool reception from EU finance officials on Friday in Poland where he went to propose the leverage idea and warned of "catastrophic risk" if Europe fails to act more firmly. Some EU ministers rankled at what they saw as a U.S. lecture.

But market participants were confident its practical appeal would eventually win the day. Leveraging the EFSF costs European governments nothing upfront, they duck the political difficulty of raising more funds if a major EU country runs into trouble, it provides funds to recapitalize banks if needed and would earn them market confidence. Semi-annual meetings at the International Monetary Fund and World Bank this week give EU leaders a further chance to discuss its merits.

* On bank liquidity, the European Central Bank's bold action last week to arrange three-month dollar funding for banks has shown ECB capacity to lead -- despite German dissent within its ranks -- and alleviate liquidity problems for European banks.

* On bank solvency, the issue is trickier. Europeans sharply disagree with U.S. officials and the International Monetary Fund that their banks need more capital. The IMF has estimated a 200 billion-euro shortfall, a number that may be revisited in an IMF report this week. If EU officials agree to flexible usage of the EFSF, they could recapitalize the banks quickly.

* On sovereign solvency, governments continue to make progress, albeit slow, in reducing budget deficits. Italy last week adopted a plan for a balanced budget by 2013. In the United States, President Barack Obama on Monday lays out his preferred course for medium-term deficit reduction.

The final ingredient is the political resolve to stick to this package of programs. Eswar Prasad, senior fellow at the Brookings Institution, said the job of the IMF this week is to nudge countries in this direction and highlight serious dangers ahead.

"The alternative is political paralysis, which we are seeing in many of these countries and could lead to very substantial risks for the longer term. And that's the big concern," he said.