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Eurozone crisis: A deft way to buy time

By Ralph Atkins in Frankfurt

ECB chief Mario Draghi has helped hold off a credit crunch but deep economic and political problems remain

The dining room of the European Central Bank's Frankfurt headquarters, with its deep-orange carpet and contemporary artwork, has been the scene of innumerable intimate, high-level meetings since the single currency's launch 13 years ago. But when the history of the eurozone crisis is written, a lunch last November for 25 chief executives of leading European banks, hosted by Mario Draghi, the new ECB president, is likely to rank among the most important.

The guests were anxious for ECB action, fretting about looming liquidity difficulties. There was a sense of fear, recalls one. The escalating sovereign debt crisis had paralysed financial markets, leaving banks short of crucial funding; the risk of a disaster that would reverberate around the global economy was soaring. "What is important is to restore confidence," Federico Ghizzoni, chief executive of Italy's UniCredit, told the Financial Times before heading off for the Frankfurt meeting.

For Mr Draghi, the message was uncomfortable. Arriving at the ECB barely two weeks earlier, the former governor of Italy's central bank had not appeared to be a policymaking activist. "He was very cautious – rightly so," says one who knows him.



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The ECB would not backstop government finances, Mr Draghi had announced. A sovereign bond-buying programme launched by Jean-Claude Trichet, his predecessor, would be strictly limited. Rather, politicians would have to resolve the crisis, with measures including fiscal austerity, he had urged. He was acutely aware of the eurozone's fraught politics and wary of further upsetting Germany's sceptical leaders and its powerful Bundesbank, which were concerned at risks the ECB had already taken on to its balance sheet.

But even as his guests were being offered white wines from the nearby Pfalz region that Wednesday in mid-November, Mr Draghi – who today marks 100 days in office – was firming up an idea that would turn eurozone fortunes or at least dispel the impression that it was on the brink of collapse. Later, convinced by his conversation with bankers that it had a chance of success, Mr Draghi and ECB executive board colleagues thrashed out details of an unprecedented offer to the banks of cheap loans lasting three years in any quantities they liked. The aim was to provide a "wall of money" to shield the banking system and prevent a European version of the 2008 collapse of Lehman Brothers.

The effect of the long-term refinancing operation, approved by the ECB's 23-strong governing council on December 8, was dramatic. Just before Christmas, 523 banks borrowed a total of €489bn – equivalent to about 5 per cent of eurozone gross domestic product. In doing so, they revealed Mr Draghi to be a swift, pragmatic decision-maker. The crisis is far from resolved – Greek indebtedness could yet plunge the eurozone back into turmoil. But Mr Draghi has proved capable of buying time. "Everyone thought he was going to be conservative, but he stepped right in," says Martin Lück of UBS in Frankfurt.

At a stroke, the ECB provided banks with funds to cover a surge of bond refinancing due in the first quarter of this year that could have proved a tipping point. The boost to confidence has thawed some financial markets and led to a fall in borrowing costs for some crisis-hit countries. At the World Economic Forum in Davos, Switzerland, last month, Mr Draghi said the ECB's action had "avoided a major, major credit crunch".

Bank borrowing:
Divergence danger in a collateral change

However generous the ECB may be in providing liquidity, eurozone banks must still provide collateral when borrowing funds. Bankers who met Mario Draghi at a crucial November 16 gathering in Frankfurt expressed concern at the shortage of eligible assets – a potential threat to the ECB's plan to offer unlimited three-year loans.

While the pool of assets that eurozone banks could use as collateral is estimated at about €14tn, these are not necessarily held by the institutions that need liquidity most. So, alongside his loan plan, the new ECB president

The operation's success was the more surprising because markets and eurozone politicians had initially missed its significance, focusing instead on the bond-buying programme Mr Trichet had begun in May 2010 at the start of the Greek crisis. Despite his comments to the contrary, Mr Draghi was expected to ramp it up. Options were discussed in the ECB and featured in talks with bankers at the lunch on November 16. In a speech to the European parliament on December 1, he appeared to set out his terms for a policy change, urging a new eurozone "fiscal compact" binding politicians to stronger rules on public finances.

In fact, Mr Draghi had serious reservations about the bond purchases, which he has since sought to run down. When Mr Trichet expanded the programme in August to cover Italian and Spanish bonds, the positive effects were short-lived. Silvio Berlusconi, then Italy's prime minister, reneged on reform promises. Mr Draghi was not afraid of telling governments what they should do – but he was determined to stop the supposedly independent central bank appearing to wheel-and-deal with politicians.

There was another reason for Mr Draghi's scepticism about the bond purchases. The Bundesbank saw them as moving perilously close to breaking a European Union ban on central banks financing governments, meant as a guard against fiscal profligacy. Mr Draghi had seen how the council had split

set about changing the collateral rules to give more responsibility to national central banks in the 17 eurozone member states.

The ECB already accepts "asset-backed securities" – bonds backed by loans. In future, countries can make their own temporary arrangements for accepting additional "credit claims" – bank loans, for instance – as collateral. The result could be different standards being applied in different countries.

The catch under Mr Draghi's scheme is that the national central banks will have to bear the risks themselves. So if a bank that has borrowed from the ECB runs into trouble and losses are incurred, there will be no sharing of the burden with other eurozone countries – as is currently the case.

Along some corridors in Frankfurt there are mutterings about the "Balkanisation" of eurozone monetary policy. Some fear this could let national authorities give local banks unfair advantages over foreign rivals, thus undermining the ECB's aim of fostering economic integration.

But a main reason for Mr Draghi's move was expediency. An agreement on a common approach would have been hard to reach in time for the second offer of three-year ECB loans, scheduled for the end of this month. He also avoided complaints from northern European countries that they were being exposed to further risks from crisis-hit southern Europe.

What is more, Mr Draghi could argue that the soaring interest rates faced by crisis-hit members have already Balkanised monetary policy. The ECB hopes his action on collateral will help to narrow those divergences.

were not prepared for such an eventuality. Mr Trichet would have sought a stronger consensus on the council; Mr Draghi went with a simple majority.

"He has not been shy – he has not been what you might have feared from an Italian appointed instead of a German with the Bundesbank watching," says Jean Pisani-Ferry, head of the Bruegel think-tank in Brussels.

Mr Draghi's streamlined management style reflects the years between 2002 and 2005 he spent as a Goldman Sachs banker, after heading Italy's Treasury and before joining the Italian central bank. He prefers frank language to tortuous central-bankese. There is more delegation than under Mr Trichet, and long-winded colleagues are subject to humorous put-downs. A governing council meeting late in January, scheduled for a Thursday morning, was completed over dinner the night before.

Focus is now on a second three-year LTRO due this month. Bankers report that demand could be twice as great as in December.

For Mr Draghi, meanwhile, the challenges are far from over. Led by Angela Merkel, German chancellor, eurozone politicians have agreed a "fiscal compact" to impose public spending discipline along lines proposed by the ECB president – but they have refrained from suggesting further action by the central bank in response. Even if the Greek crisis is successfully navigated, however, the ECB may have to cut interest rates further to avert a deep eurozone recession or damaging deflationary forces. Government bond purchases may yet have to be stepped up.

under Mr Trichet, and he was especially keen to keep the Germans on side. He needed to find another way out for the eurozone.

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Accounts vary of how hard the bankers attending the private lunch lobbied for a three-year LTRO. Pressure on them was certainly acute, amplified by tougher capital requirements demanded by European regulators. As well as UniCredit's Mr Ghizzoni, those attending included Alfredo Sáenz, chief executive of Spain's Santander – although Deutsche Bank's Josef Ackermann was a notable absentee.

But the idea of the ECB going beyond traditional provision of short-term liquidity was not new – and work had started on a possible multi-year LTRO. After Lehman Brothers' collapse, the ECB dropped the pre-crisis system in which banks bid for liquidity and met demand in full. By May 2009 it was temporarily prepared to offer one-year loans. For some ECB insiders, this was the eurozone equivalent of "quantitative easing" – boosting the economy but through the banking sector rather than asset purchases. "The whole concept of getting around European rules and doing 'QE' without calling it QE was extremely clever – but it was Trichet's idea," says Professor Lucrezia Reichlin of the London Business School and former head of research at the ECB.

Last summer ECB staff had prepared briefing notes on options for further action. One of Mr Trichet's last acts was to reintroduce one-year LTROs. Take-up, however, was low.

Mr Draghi's calculation, backed by his talk with the bankers, was that three-year loans would make a decisive difference, fitting better with the maturity structure of banks' financing and their loans to the real economy. Moreover, offering favourable terms – including an interest rate set at the average of the ECB's main policy rate over the three years – meant there was more chance of lenders using it. "Banks would not go for one-year liquidity because there was too much stigma attached – but if you didn't go for three years, you would be stupid," says one person who attended November's meeting. The idea that eurozone banks might use the funds to buy the high-yield bonds of distressed governments was discussed on various occasions by council members but was not part of the official justification.

Some remained worried about what would happen in three years' time when funds have to be repaid, or the dangers of storing up risks of inflation or future financial market bubbles. Crucially, however, there was scant resistance from the Bundesbank. It would have preferred less generous terms but could not dispute that the job of central banks is to provide adequate liquidity to solvent lenders. Jens Weidmann, Bundesbank president, warned in a speech last week that excessively generous liquidity provision could encourage banks into risky ventures and create inflationary dangers, but he has not sought to block Mr Draghi's plan.

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Mr Draghi – who became ECB president after Berlin's first choice, Axel Weber, then Bundesbank president, pulled out of the race a year ago – has shown deftness in other ways. Rule-changes on which assets banks can use as collateral to obtain ECB liquidity should increase significantly the amounts they can borrow. He has also cut the ECB's main interest rate twice by a quarter percentage point, returning it to the record low 1 per cent seen in the depths of the 2009 recession.

No interest rate change is expected on Thursday's governing council meeting. However, the last cut – in December – surprised many on the council. Mr Draghi had not pushed for a reduction and his staff

Structural weaknesses in many eurozone economies and flaws in the single currency's construction remain chronic. The three-year LTRO acted merely as "a painkiller", warns Jörg Krämer of Commerzbank in Frankfurt. Mr Draghi may try to preserve a reputation for cautiousness but it is his actions that will count. As Mr Krämer adds: "It is always better to look at what people do and not what they say."

Additional reporting by Rachel Sanderson, James Wilson and Victor Mallet



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