How the ECB changed its mind-set

Widening turmoil pushed bank into role of crisis manager

By Carter Dougherty

FRANKFURT: The European Central Bank's main task is to keep inflation down. But over the past month, it has thrown caution to the wind in trying to prevent Europe's financial system and integrated economy from falling apart.

The ECB has transformed itself into a crisis manager of the sort that its architects could hardly have imagined when the bank took up its work 10 years ago. The bank, charged with managing the euro, was given a single mandate — to keep prices under control.

Lately, however, the central bank has cast aside worries about inflation, cutting interest rates once already, with more cuts in the pipeline. At the same time, it is lending ever more cash to strapped banks.

Most notably, the ECB president, Jean-Claude Trichet, waded into the highly politicized question of recapitalizing European banks as it became clear that little else would break the fever of plunging financial markets. Always quick to emphasize the importance of the ECB's credibility, Trichet put it on the line to persuade elected officials to move despite their initial reluctance to do so.

"For the national governments, this was a task they would just have soon let alone," said Gernot Nerb, head of sector research at the Ifo Institute. "The ECB played a role as a kind of mediator in Europe."

The collapse of Lehman Brothers on Sept. 15 turned Wall Street's traumas into a global financial crisis and pushed the ECB to act much more like the Federal Reserve, with its forward-leaning style of managing financial challenges. With a European credit crunch looming, even the ECB officials most worried about inflation changed their minds about the most important threat to Europe's economy.

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As a result, many analysts expect the ECB to cut its benchmark rate by a half-percentage point when it meets in early November, as it did on Oct. 8 in conjunction with several other central banks.

Rates will go lower next year, too, as the ECB fights to limit the worst effects of the recession that is now evident.

The ECB, which critics have accused of being behind the curve, has moved lately with astonishing speed.

Within 24 hours after Lehman filed for bankruptcy, the currency swap market in London dried up. These financial instruments allowed European banks to convert the euros or pounds that central banks had provided so they could meet obligations on dollar-denominated liabilities that were often linked to the U.S. mortgage market.

Within two days of Lehman's collapse, the ECB's decision-making body, which comprises 6 people in Frankfurt and 15 national central bank governors, approved a plan of action proposed by the Fed earlier in the week. Instead of ad hoc injections of cash, the central banks agreed Sept. 17 to provide $180 billion in overnight dollar loans and promise to do it for as long as necessary.

After the operation began, Trichet lauded the "intimate cooperation" that allowed central banks to carry it out smoothly, while playing down any systemic risk within banks.

"We have a responsibility as regards liquidity providing," he said. "We have no responsibility as regards the solvency issue that might emerge here and there."

Getting over the interest rate hurdle took longer.

The ECB had fretted about inflation since the beginning of the crisis and refused to cut rates as the Fed did. Oil prices, which peaked at $147 a barrel in July, drove euro-zone inflation over 4 percent, more than twice the bank's target. This led the bank to raise its benchmark rate to 4.25 percent in July.

At its Oct. 2 meeting, with the fate of the $700 billion U.S. bank rescue plan

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How ECB changed its mind-set to confront widening crisis

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still undecided, the ECB said it was reconsidering the need for rate cuts. Inflation was still far above its target, but the abrupt contraction in bank credit meant that growth would slow sharply, making it all but impossible to pass on higher costs — whether from wages or raw materials — to consumers

To many analysts, who noted that economic indicators had been falling since early summer, the ECB was belatedly and reluctantly acknowledging the obvious.

"I see them as someone who had a loss-making position for a long time and finally closed it out," said Thomas Mayer, chief Europe economist at Deutsche Bank in London. "They didn't panic — they just made the wrong judgment."

ECB views were changing on other matters as well.

The "here and there" case-by-case approach to ensuring the solvency of the banking system was proving inadequate to the task. Government officials had spent the previous weekend arranging rescues for Fortis, a Brussels-based bank, and Hypo Real Estate, a German lender.

With investors pounding other bank stocks, Trichet began to speak obliquely about the need for elected officials to act more expansively.

"In exceptional cases where financial stability is at stake and we have done everything we can in terms of providing liquidity," Trichet said on Oct. 2, "it is important that governments also make the appropriate decisions."

Two days later, Trichet joined a summit meeting of major European countries in Paris and made the case for a broader effort to support banks. But he was also aware that emulating the United States with a single bailout fund was impossible because Europe does not have a federal budget.

The intellectual leap was easier for European central bankers to make than the politicians.

Banks in Scandinavia needed emergency funds because of bad real estate loans in the early 1990s, and governments there stepped in to recapitalize them and buy up the shrunken assets.

Having studied that approach, ECB officials knew that if done right, it was not as costly as headline numbers might suggest, since the government could make back money as values returned to normal. They also knew that every modern banking crisis had ended with a sovereign guarantee for banks in some form.

But the idea ran aground at the summit meeting, where Chancellor Angela Merkel was wary of financing rescues of non-German banks. A Dutch proposal for each country to commit to providing the equivalent of 3 percent of its gross domestic product went nowhere as well.

Financial markets fell sharply the following Monday, Oct. 6, a prelude to a long, scary week on exchanges from Tokyo to London to New York.

By then, after signaling its willingness to cut rates, the ECB was ready move. The Fed had long wanted to pursue a coordinated rate cut, insiders said, but in the collegial world of central banking, it could not pressure the ECB.

What the Fed could do, when a globally coordinated rate cut was announced Oct. 8, was communicate the decision in European terms, emphasizing that the financial situation had "diminished further the upside risks to price stability."

As one person briefed on the ECB-Fed discussions put it: "They got to go where they wanted to be without being seen as panicking. And the economy is in a much better situation with lower rates."

On Sunday, Oct. 12, Trichet joined the heads of state from the euro zone for the second summit meeting in Paris in a week, and by then the plummeting financial markets had brought the Germans around. Following the lead of the British prime minister, Gordon Brown, the leaders hashed out the rescue packages that Trichet and the French president, Nicholas Sarkozy, called for a week earlier.

The ECB piled on even more changes. On Tuesday, Oct. 14, it made good on an earlier promise to provide unlimited liquidity at its new policy rate of 3.75 percent, and lent €185 billion, or about $250 billion to banks.

On Wednesday, bank drastically expanded the list of collateral banks can use for lending, opening up a whole new source of funding.

Europe still faces an economic downturn. But "it's now conceivable that the financial crisis may be terminated more quickly," said Charles Goodhart, a former top official at the Bank of England.

"We had an adverse shock," he added, "but now we've had a policy response that looks like it might work."