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No limits seen to E.C.B.'s arsenal for aiding nations

FRANKFURT

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The European Central Bank has succeeded in pushing down the interest rates on Spanish and Italian government debt since announcing an unprecedented intervention on Sunday night, but analysts say the bank still needs to convince investors it has the stamina to withstand what could be a long struggle against market turmoil.

The E.C.B. intervention, which is much more ambitious than previous forays into the bond market, has fueled debate about how far the bank legally can go under its charter. According to insiders and analysts, the answer seems to be: as far as it wants.

Spanish and Italian government bond prices rose and their yields fell Tuesday after the E.C.B. stepped in for a second consecutive day to purchase their sovereign debt, part of expanded efforts to prevent the euro zone debt crisis from deepening in two of its largest economies.

As it has when buying Greek bonds in the past, the bank will portray its interventions as a means to maintain control over interest rates and keep down inflation, not as a rescue of any particular country, which is forbidden by treaty. And it will make a show of taking as much money out of circulation as it spends buying bonds, to avoid the appearance that it is printing money or flooding the economy with cash the way the U.S. Federal Reserve has done with its so-called quantitative easing.

But the E.C.B., in an effort to prove its resolve, will not acknowledge any limitations on its monetary policy arsenal — and, in the worst case, might even try quantitative easing if there are signs of deflation. "We do what we judge necessary to be sure that we deliver price stability," Jean-Claude Trichet, the president of the central bank, said last week, repeating a phrase he has used often.

E.C.B. watchers say that the message applies even more broadly than that. Confronted by a fundamental threat to the euro or to the European banking system, the central bank would have no choice but to act. "They will do whatever it takes because they will be forced to," said Jacques Cailloux, chief

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European economist at Royal Bank of Scotland. "There are no technical impediments to buying unlimited amounts" of bonds, he added.

Previously the E.C.B. had only intervened in the much smaller markets for Greek, Portuguese and Irish bonds, spending €74 billion, or $105.6 billion. Some analysts say the bank may need to spend more than 10 times that to maintain control over yields on Spanish and Italian debt.

The E.C.B.'s active purchases of Spanish and Italian bonds, reported by traders but not officially confirmed by the central bank, came amid broader market turmoil following the decision Friday by Standard & Poor's to lower the gilt-edged U.S. debt rating by one level, to AA+.

Last week, the cost of borrowing for both Spain and Italy soared to record highs, with yields on their 10-year bonds topping 6 percent, a level that could raise a country's interest payments to ruinous levels. Poor economic data has amplified worries that politically weak governments in Madrid and Rome would not manage to clean up their public finances as quickly as previously promised. Spain grew 0.2 percent in the second quarter, less than expected.

Elena Salgado, the Spanish finance minister, insisted Tuesday that Spain was on track to meet its fiscal targets this year. "Spain's fundamentals show we are very far from requiring a bailout," Ms. Salgado told Onda Cero, a Spanish radio station.

The yield on Spain's benchmark 10-year government bonds fell an additional 0.09 percentage point, to 5.030 percent, Tuesday after reaching a record high of 6.458 percent on Aug. 2. The yield on 10-year Italian bonds, meanwhile, had fallen to a one-month low of 5.146 percent.

Yet there were growing signs of heightened tensions in the banking system. Money market indicators showed banks' reluctance to lend to each other is approaching levels not seen since the collapse of investment bank Lehman Brothers in September 2008.

The E.C.B. has acknowledged the interbank tensions, last week expanding the low-cost loans it offers to banks to ensure they have enough cash to conduct operations. To keep Spanish and Italian bond yields at sustainable levels over the long term will be a huge challenge, as investors test the bank's resolve. "Once they have started buying it will be difficult to stop buying," Mr. Cailloux of R.B.S. said.

Mr. Trichet said last week that he wanted European governments to take over the bond buying, as they have agreed to do. He also insisted that European governments do more to reduce debt and remove regulations and bureaucracy that impede growth, particularly in countries like Italy and Greece.

Uri Dadush, an analyst at the Carnegie Endowment for International Peace, argues, like several other economists, that the financial crisis is becoming too big for any one central bank or government to manage, and that they must coordinate their efforts. There are signs that leaders are poised to act if necessary.

On Sunday, officials from the Group of 7 nations — including the U.S. Treasury secretary, Timothy F. Geithner, and the Federal Reserve chairman, Ben S. Bernanke — held a conference call and issued a statement afterward saying they were ready to "take all necessary measures to support financial stability and growth."

Mr. Trichet has not signaled any impending coordinated effort but often emphasizes his close relationship with Mr. Bernanke. "We always have a very close relationship with our sister institutions everywhere in the world," Mr. Trichet said last week.

The bond market volatility has hit Spain at a time of political fragility. On July 29, the Spanish prime minister, José Luis Rodríguez Zapatero, called an early general election for Nov. 20, bowing to pressure from opposition politicians and business leaders after his Socialist Party suffered a historic defeat in regional and municipal elections last May.

Opposition politicians have since urged Mr. Zapatero to push forward the election date even further, this time to October, in response to investors' fears about a lame-duck political leadership at a time of market turmoil.

Ms. Salgado disputed that idea Tuesday, saying that another change in the election calendar would not be "a good idea." Instead, she pointed to measures announced this month to help reduce the deficit more quickly, including a change in the corporate tax calendar and a cut in prescription drug spending, as evidence that the government was pushing through with its fiscal plans.

Antonio Garcia Pascual, an analyst in London for Barclays Capital, wrote in a note Tuesday that the additional measures should enable Spain to meet its deficit target for next year. But he warned that federal government belt-tightening risked being offset by fiscal indiscipline among regional governments, unless Madrid stepped in.

"The risks of fiscal slippages in the regions are likely to persist," he said, "and may remain a concern for the markets so long as more bold steps are not taken."

Raphael Minder reported from Madrid.