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Draghi calls for new eurozone 'compact'

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By Ralph Atkins in Frankfurt

Mario Draghi, European Central Bank president, has called for a "fiscal compact" between governments to restore investor confidence in the eurozone – and hinted such a step could pave the way for a more aggressive ECB response to the region's debt crisis.

A fiscal compact, binding governments to stronger public deficit and debt rules, would be "definitely the most important element to start restoring credibility", Mr Draghi told the European parliament. "Other elements might follow, but the sequencing matters," he added.

His comments were the clearest indication yet of the ECB leaving itself room for manoeuvre if eurozone leaders agree at a summit next week on clear steps towards a eurozone fiscal union. They came just hours before Nicolas Sarkozy, French president, was due to set out his proposals for restoring stability to the eurozone.

Mr Draghi highlighted the eurozone's rapidly deteriorating economic outlook by warning that "downside risks" had increased and that bank sector weaknesses had led to a worrying credit squeeze. "We have observed serious credit tightening in the most recent period which, combined with a weakening in the business cycle, does not bode at all well for the months to come," he said. Small- and medium-sized companies were being hardest hit.

The ECB president added: "The most important thing for the ECB is to repair the credit channel."

Earlier on Thursday, purchasing managers' indices for China showed manufacturing activity contracting for the first time in three years – casting a further cloud over global growth prospects. A similar survey confirmed eurozone manufacturing activity contracted in November for the fourth consecutive month.

Mr Draghi said a fiscal compact "would enshrine the essence of fiscal rules and the government commitments taken so far, and ensure that the latter become fully credible, individually and collectively".

He went on: "If there is an anchor in the long term, it is easier to maintain trust in the short term. After all, investors are themselves often taking decisions with a long time horizon, especially with regard to government bonds.

"A new fiscal compact would be the most important signal from euro area governments for embarking on a path of comprehensive deepening of economic integration. It would also present a clear trajectory for the future evolution of the euro area, thus framing expectations."

The ECB has already spent more than €200bn buying eurozone government bonds but is increasingly seen by economists and eurozone politicians as crucial to resolving the crisis. One option, which has been looked at by the ECB, would be to set a limit on eurozone government bond yields or the spread between the interest rate on German and other eurozone government debt. However, the ECB governing council still seems some way from agreeing such a radical step.

Mr Draghi warned, however, that the ECB had to stick within European Union treaties. Its action in government bond markets was limited and temporary and aimed at ensuring its interest rate decisions were "transmitted" to the real economy. "It is not eternal, and it is not infinite."

With evidence mounting that the eurozone is already in recession, the ECB is expected by many economists to cut its main interest rate again at its governing council meeting next Thursday. At its November meeting – the first chaired by Mr Draghi – official borrowing costs were cut from 1.5 per cent to 1.25 per cent.

However, some ECB council members may prefer to hold fire on interest rates in order to focus attention on a significant expansion of ECB help for the eurozone's distressed banking system. On the agenda will be the introduction of loans lasting as long as three years as well as a broadening of the pool of assets that banks can use as collateral to obtain ECB liquidity.

In the European parliament, Mr Draghi reiterated: "We are aware of the continuing difficulties for banks due to the stress on sovereign bonds, the tightness of funding markets and scarcity of eligible collateral in some financial segments."

On Wednesday, the ECB joined the world's other main central banks in slashing the cost of dollar liquidity for banks.