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ECB to set sights on helping eurozone banks

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By Ralph Atkins in Frankfurt

The European Central Bank is expected to escalate its response to the eurozone crisis significantly this week, with an immediate focus on measures to shore up the region's weakened banks.

Thursday's ECB council meeting is likely to agree steps aimed at preventing a severe credit squeeze that would drive the eurozone deeper into recession, and at averting acute problems at individual banks. They will follow the intensification of tensions in the bank sector in recent weeks.

The ECB meeting in Frankfurt will act as a prelude to eurozone leaders' summit meetings starting in Brussels on Thursday evening. By next weekend agreement on steps towards a fiscal union could have paved the way for the ECB to provide more aggressive support for strained eurozone government bond markets, which many economists believe is crucial to secure the eurozone's future.

However, the central bank will remain wary of escalating bond purchase programmes until it feels politicians have come up with a fiscal plan of attack. If a legal means can be found, the ECB could demand an indemnity against losses on its bond purchases, which have already exceeded €200bn. That could further encourage politicians to take action and ensure the bank's independence.

"On Thursday, the ECB has to put the bandages in place to reduce the risk of a big accident before the eurozone fiscal plan is finally put in place to address the problems at the heart of the crisis," said Erik Nielsen, chief economist at UniCredit.

In contrast to its bond market intervention, the ECB sees help for the financial system as its clear responsibility, added Jacques Cailloux, European economist at Royal Bank of Scotland. "It is absolutely their space, and that enhances the chances of getting something quite meaningful for the banks."

The ECB has become increasingly gloomy about eurozone economic prospects. Mario Draghi, ECB president, told the European parliament last week: "We have observed serious credit tightening...which, combined with a weakening in the business cycle, does not bode at all well for the months to come." Small and medium-sized companies were being worse hit. "The most important thing for the ECB is to repair the credit channel."

At least some ECB council members fear the pace of contraction over the winter will be significantly worse than the "mild recession" forecast last month by Mr Draghi. The bank's growth forecast for 2012 is likely to be revised down significantly from the range of 0.4 per cent to 2.2 per cent forecast in September.

Financial markets have pencilled in another cut in ECB interest rates after the reduction from 1.5 per cent to 1.25 per cent at November's meeting. However, some council members may argue inflation pressures have not abated sufficiently to justify cutting official borrowing costs – the annual rate remained at 3 per cent in November. Holding fire on interest rates would also save policy ammunition for 2012 – and focus attention on steps taken to help banks.

Among the most likely measures, offers of loans to banks lasting as long as three years would boost their financial security and allow longer-term planning – in turn enabling them to extend more credit to the real economy. A broader pool of assets deemed acceptable as collateral could help individual banks, especially those in countries worst hit by the crisis, which have seen the value of existing collateral falling sharply. For instance, the ECB could relax the rules on the use of asset-backed securities as collateral by banks obtaining its liquidity.

A more radical but less likely option would be for the central bank to start buying bonds issued by banks. That would boost lenders' finances and get around the problem of some being reluctant to use ECB liquidity because of the risk to their reputation if details became public.

In a sign of banks' nervousness, increasing sums are being parked at the ECB instead of lent to other banks or pumped to the economy. Use of the central bank's "deposit facility" hit €314bn late last week, the highest since June last year.