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Politicians turn screw on ECB president

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By Ralph Atkins in Frankfurt

Who, if needed, could pull the eurozone back from the brink of disaster? One person attending Wednesday's European leaders' summit could provide an immediate and forceful response if, say, a Greek exit from the eurozone threatened financial and economic chaos.

To the frustration of Mario Draghi, its president, the European Central Bank is once again being eyed as a possible saviour of Europe's monetary union.

Since he became president last November, Mr Draghi has urged bolder action by politicians to strengthen public finances and build effective "firewalls" against spreading crises. Earlier this month he scolded governments for creating a European Financial Stability Facility that "could hardly be made to work". He saw the unelected ECB's role as strictly limited.

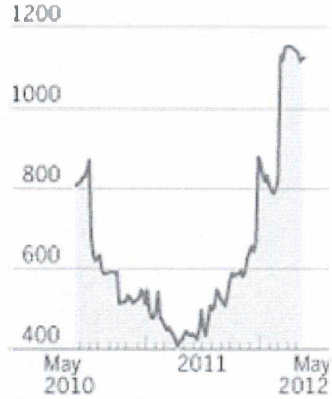
Instead, eurozone politicians, led by François Hollande, France's new president, have sought to turn the tables, demanding action from Frankfurt.

But, at crucial moments, the ECB has acted before. In May 2010 when Greece's debt crisis first exploded into a eurozone threat, the ECB launched a government bond buying programme. Last December, Mr Draghi introduced unlimited offers of cheap three year loans to eurozone banks.

"There is a constant frustration at the ECB with politicians," says Erik Nielsen, chief economist at UniCredit. "But at the end of the day, they have to pick up the casualties ... As a central banker you have to 'do what you have to do' if the system breaks down."

If a Greek eurozone exit threatened to cause bank runs elsewhere, the ECB could swiftly repeat its three-year liquidity offers. Some banks might run out of assets that can be used as collateral to obtain normal ECB liquidity. But the ECB could relax its rules. Or it could authorise widespread use of "emergency liquidity assistance" – a well-tested facility which allows national central banks to help banks in difficulties by creating extra euro. That could buy time for banks' finances to be rebuilt – using government or European funds.

ELA is already being used on a large scale in Greece, where as much as €100bn has been drawn. Greeks are testing the tolerance of the Bundesbank, however. The German central bank noted on Wednesday that help for Greece already entailed "considerable risks" for eurozone central banks and should not be increased.



Another option for the ECB would be to reactivate its government bond purchase scheme with the aim of capping governments' borrowing costs and shoring up investor confidence in Europe's monetary union.

Under Mr Draghi the programme, by which the ECB has acquired €212bn in bonds, has been shelved amid fears it encouraged governments to go slow on reforms. The programme's future effectiveness has also been questioned.

Because the ECB only bought in spurts in the past, its reactivation could encourage a rush to sell by investors. Investors are also worried about the ECB's exemption from writedowns imposed on other Greek government bond holders – which suggested it would also get preferential treatment in future eurozone bailouts.

But the bond buying programme's revival, possibly on an enhanced scale and buttressed by the European Stability Mechanism, the successor vehicle to the EFSF, would "create in markets the idea that selling eurozone periphery governments' bonds is not a one-way bet," said Gilles Moec, European economist at Deutsche Bank.

To revive the eurozone economy, the ECB could also cut its main interest rate, currently 1 per cent. The direct economic effects would be modest, although a resulting fall in the euro would boost exporters' prospects. But eurozone banks borrowing from the ECB would benefit. Moreover, by approaching a zero interest rate, the ECB could signal it was ready for the next step: US Federal Reserve and Bank of England-style "quantitative easing" – creating money to buy assets. Local twists could be applied under eurozone QE, for instance by buying assets that helped particularly the crisis-hit eurozone countries.

A significant risk is divisions within the ECB undermining the effectiveness of any steps it takes. The bond buying programme was constrained by resistance by the Bundesbank, which feared the boundaries between fiscal and monetary policy were being blurred. Jens Weidmann, Bundesbank president, still sees clear limits to central bankers' role – he rules out, for instance, the ECB allowing the ESM to tap its unlimited liquidity supplies. But even the Bundesbank would be flexible in a worst-case scenario, say some analysts. "If catastrophe threatened, creativity would be much higher – even at the Bundesbank," said one.