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E.C.B. chief faces higher stakes in bid to calm fears

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Investors expect action on debt crisis, but bank needs to buy more time

BY JACK EWING

The last time Mario Draghi addressed the news media after a meeting of the European Central Bank, on Aug. 2, he disappointed investors who wanted him to crack his whip and immediately bring bond markets to heel. The markets tanked even before Mr. Draghi was done speaking.

Only in subsequent days and weeks did the bond markets calm down, as investors evidently absorbed his underlying message that the E.C.B. intended to take meaningful measures against the euro debt crisis, even if quick remedies were not possible.

But Thursday, when the E.C.B. meets again, Mr. Draghi, the central bank's president, could have a far harder time reconciling the expectations of twitchy financial markets with the limitations of his own power. Although investors are counting on bold action, analysts say the E.C.B. probably still needs more time to resolve internal differences and deliver on a promise to use its financial clout to tame runaway borrowing costs for the most troubled euro zone countries.

"Market expectation of Draghi's ability to maneuver may be exaggerated," said Marie Diron, a former E.C.B. economist who now advises the consulting firm Ernst & Young. "That could lead to a selloff."

Some analysts do expect the E.C.B. to cut the benchmark interest rate to 0.5 percent Thursday, from its already re-

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cord low of 0.75 percent. Although that reduction might not impress investors as much as a bold intervention in the bond market would, it could at least indicate Mr. Draghi's commitment to his July promise of doing whatever it took to preserve the euro.

The E.C.B. meeting is probably the central event, but not the only one, in what is likely to be an action-packed week for the euro zone. Political leaders will also continue making the rounds of one another's capitals to plot crisis strategy.

One of the most closely watched meetings, also Thursday, will take place when Angela Merkel, the German chancellor, visits the Spanish prime minister, Mariano Rajoy, in Madrid. Spain's debt drama seems to have entered a dangerous new phase, with some of the country's biggest regions requesting financial aid from a central government already staggered by its own high borrowing costs.

Mr. Draghi at least temporarily mollified markets last week with an opinion piece in the German newspaper Die Zeit that was widely interpreted as signaling the E.C.B.'s determination to begin buying the bonds of troubled euro zone governments soon, despite resistance from Germany. Exceptional measures may be required, Mr. Draghi wrote, "when markets are fragmented or influenced by irrational fears."

Top E.C.B. officials have indicated that they are working overtime to determine how best to keep borrowing costs for countries like Spain and Italy at levels considered affordable. Mr. Draghi and other members of the E.C.B. executive board even canceled plans to attend the annual meeting this past weekend of global central bankers in Jackson, Wyoming, saying there was too much to do in Frankfurt.

So far, the mere promise of E.C.B. action has had an effect. Since spiking in late July, bond yields, a measure of a government's borrowing costs, have fallen below 6 percent on 10-year debt for Italy and below 7 percent for Spain — levels considered acceptable, if not exactly comfortable.

But the yields, which have begun to edge higher again in recent days, are linked to expectations that Mr. Draghi will provide specifics of the E.C.B.'s bond-buying strategy at the news conference Thursday after the meeting of the central bank's governing council.

Mr. Draghi is thought to have the support of most of the council's 23 members. But he must contend with stiff, vocal resistance to bond buying from Jens Weidmann, the president of the German Bundesbank.

The Bundesbank declined to comment Friday on a report in Bild, a German newspaper, that Mr. Weidmann had even threatened to resign in protest over the bond buying. The Bundesbank would only refer to an interview Mr. Weidmann gave to Der Spiegel magazine last week, in which he said, "I can do my job best by staying in office."

While Mr. Weidmann has been the only member of the governing council to object publicly to E.C.B. bond buying, some others are likely to share some of his concerns. That group probably includes Yves Mersch, governor of the Central Bank of Luxembourg, and Erkki Liikanen, governor of the Bank of Finland. Spokesmen for the two men declined to comment.

These quiet dissenters may already have won concessions from Mr. Draghi that could constrain a new bond-buying program. For example, their objections may well be the reason Mr. Draghi said this month that any bond purchases would focus on short-term debt.

By buying bonds that mature in two years or less, the E.C.B. would keep the pressure on countries to continue reducing debt and improving economic performance. Governments would know they needed to face investors again in a fairly short time.

The concern is that constraints imposed by Mr. Weidmann and others could dilute the effects of E.C.B. bond buying, making it less effective.

In any case, actual bond buying by the E.C.B. is probably at least several weeks away. Mr. Draghi said in August that the central bank would intervene in bond markets only in concert with the new E.U. rescue fund, the European Stability Mechanism, or E.S.M.

Countries would need to ask the rescue fund for help, Mr. Draghi said, and the fund would take the lead in bond buying, with the central bank providing backup financial support. But the fund, meant to replace a temporary bailout fund, is in legal limbo at least until the German constitutional court rules Sept. 12 on a challenge to the country's participation.

While many analysts do not expect the court to block Germany from taking part, some have warned of such a risk. "If the Court bans the German government from joining the E.S.M. for now, this will likely have major repercussions for financial markets," analysts at Morgan Stanley wrote in a note to clients.

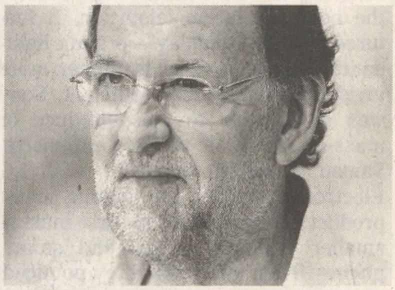
At the news conference Thursday, Mr. Draghi will very likely need to finesse the difference between investors' desire for instant gratification and the obstacles that remain before heavy-duty bond buying can start.

Investors will want to know whether the E.C.B. will continue to consider itself a preferred creditor, which raises the risk for other investors in the event a country defaults. Although the E.C.B. is expected to give up its privileged status in the debt market, that approach also carries risks. If the E.C.B. lost money on any bonds, taxpayers throughout the euro zone might ultimately have to replenish its reserves.

A promise to expose itself to future losses might be credible only if the E.C.B. took a hit on its existing holdings, namely an estimated €40 billion, or $50 billion, in Greek bonds. This year, the E.C.B. refused to accept the losses on Greek debt that private bondholders agreed to absorb. But a decision to forgive some of Greece's debt would stir outrage in Germany and some other countries.

Investors will also be asking how the E.C.B. would ensure, once it relieved market pressure, that countries like Italy would continue efforts to streamline their economies.

POOL PHOTO BY DIEGO AZUBEL



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Prime Minister Mariano Rajoy, above, of Spain, is to meet this week with Chancellor Angela Merkel, top, of Germany.

One method of punishing a backsliding country would be for the E.C.B. to let that government's borrowing costs rise again. But that would risk accelerating the crisis.

Addressing such technical and political questions Thursday, after what may be a contentious debate within the E.C.B. governing council, could be the biggest public test yet of Mr. Draghi's rhetorical skills.

"Given the damage already done, any recovery in financial stability and economic activity will take time," analysts at Credit Suisse said in a note last week. "But consistent and effective E.C.B. policy is a necessary condition for that. From what we've already heard from E.C.B. President Draghi, the E.C.B. may be prepared to deliver."

Liz Alderman contributed reporting from Paris.