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Temporary Respite

Why ECB's Tricks Won't Solve the Crisis

Ever since the European Central Bank began flooding the markets with cheap money, European banks have rediscovered their taste for sovereign bonds. But the crisis is far from over, as Standard and Poor's recent raft of downgrades showed. Some bankers are saying it's just a matter of time before yields on peripheral bonds shoot up again. *By SPIEGEL Staff*

During his first press conference of the year, European Central Bank (ECB) President Mario Draghi had been talking about the precarious state of the euro zone for almost half an hour when someone in the audience asked about Peer Steinbrück.

The former German finance minister had more or less said that the ECB was the EU's only functioning institution and that it had to get more involved in managing the ongoing crisis. With a forgiving smile, Draghi closed his long response by saying that "obviously we are always very pleased when people say that the ECB is the only institution that works."

Although it hasn't even been three months since Draghi stepped down as the Bank of Italy's governor to take over the reins of the ECB, he exudes the confidence of someone who has everything under control -- and not only in relation to the ECB, where he has reshuffled responsibilities on its governing council, but also in terms of the euro crisis.

In fact, the situation on the financial markets has noticeably relaxed. In sovereign bond auctions last Thursday and Friday, Italy and Spain had no problem raising fresh money for themselves -- and at tolerable yields too. On Thursday, while discussing the ECB's recent decision to make unlimited liquidity available to euro-zone banks, Draghi confidently stated that "the more time that passes … the more we see signs that it has been an effective policy measure."

A Wave of the Wand

Back in December, the yields on the bonds of crisis-ridden euro-zone countries had risen once again, and there were rumors that investors would boycott them in upcoming auctions. Indeed, it only looked like a matter of time before the ECB would be forced to bring out its so-called "big bazooka" and buy practically unlimited amounts of the unpopular bonds. However, at around the turn of the year, it looked like all these problems had been solved by the wave of some magic wand.

German Finance Minister Wolfgang Schäuble, a member of Chancellor Angela Merkel's center-right Christian Democratic Union (CDU), reacted to this positive development with cautious relief. He told colleagues at the Finance Ministry that the ECB's stabilization efforts appeared to be showing initial signs of success. But, he added, it was still too early to make any definite judgments.

As it turns out, Schäuble was right to be cautious. Reality already caught up with the euro's would-be saviors on Friday, when the ratings agency Standard & Poor's simultaneously downgraded the credit ratings of nine euro-zone countries. While France and Austria lost their coveted AAA ratings, countries like Italy, Spain and Portugal fell two notches in the ratings. That same day, private investors announced they had broken off talks with Greek government officials over a so-called haircut on Greek debt.

Artificial Demand

Indeed, the problems are too far-reaching to be solved with a single measure from the bank's bag of tricks. But for all intents and purposes, the ECB's new strategy is just that -- a trick. By flooding the banks with cheap money, it is artificially generating demand for sovereign bonds. In doing so, it can also cut back on its own bond purchases, which have also been highly controversial within the bank itself.

For the banks, it's a fantastic deal. They can borrow money from the ECB for three years at the prime interest rate, which currently stands at 1 percent. If they used that money, say, to buy Italian bonds last Friday, they would get the much higher interest rate of 4.83 percent. Then they could turn around and deposit these bonds at the ECB as security, and borrow even more money at 1 percent.

This new ECB strategy would appear to benefit all the major players: the banks, the cash-strapped countries and the ECB itself. But it has also triggered worries that Draghi has merely created a kind of financial perpetual-motion machine. In any case, the strategy does nothing to alter the fact that the institution ultimately bearing the risks is still the ECB -- and, with it, the taxpayers.

Since Draghi announced the new program on Dec. 8, 523 banks have taken advantage of the bargain offer to borrow almost €500 billion ($632 billion). However, instead of passing that money on in loans to companies so as to spur the economy, they have redeposited the money with the ECB. Deposits at the ECB -- which are regarded as a barometer of the banks' risk aversion during the crisis -- piled up higher and higher every night.

Then, last week, some of the banks dauntlessly used some of their liquidity to purchase Italian and Spanish bonds at the auctions. Overnight deposits at the ECB dropped by almost €15 billion.

'Printing Money'

ECB council members are pleased with themselves and their intervention. "The positive reception shows that, with this measure, the ECB has made a very important contribution to improving the banks' refinancing situation," says Germany's Jörg Asmussen, a member of the ECB Executive Board. "In the final analysis, the measure helps re-establish trust between the banks, which also makes it easier to extend loans to the real economy" -- and, he could have added, to the crisis-stricken states themselves.

"The markets have thankfully acknowledged the ECB's action from December and are expecting the central bank to continue to be ready to provide emergency assistance," says Clemens Fuest, an economics professor at the University of Oxford who advises the German Finance Ministry. In economic terms, he adds, whether the ECB purchases bonds directly, or makes money available to the banks to do so, ultimately amounts to the same thing.

"The ECB is increasingly assuming the role of a provider of public-sector finance and is helping out by printing money," says Jörg Krämer, chief economist at Commerzbank, Germany's second-largest bank. In doing so, it is drifting further and further from the role it has classically played and from the traditions of the Bundesbank, Germany's central bank, whose supreme mandate has always been to guarantee the stability of the currency.

But Draghi has another priority, namely, to rescue the euro. And he will only succeed if he manages to bring lasting calm to the markets -- and if the crisis-ridden countries make use of the time his measures buy them to reform their national economies. Still, Krämer sees a problem with this. "If the situation continues to improve," he says, "it will be hard for many governments to sell the necessary spending cuts to their citizens."

Wolfgang Reitzle, head of the German gas and engineering giant Linde, also fears that the will to reform might start flagging again. Were that to happen, he believes the burdens borne by Germans would once again increase while their willingness to finance other euro-zone states would decrease. In an interview with SPIEGEL, Reitzle argued in favor of the surprisingly drastic step of Germany leaving the euro zone.

'Paused for Reflection'

The rigorous austerity plans of Mario Monti and Mariano Rajoy, the new prime ministers of Italy and Spain, require their populations to submit to painful belt-tightening. In Spain, plans call for slashing spending by almost €9 billion. Wages for public-sector employees will be frozen, as will the minimum monthly salary, currently at €641.

Monti's package envisions €33 billion in cuts and a balanced budget by 2013. But, of course, there are some variables. This can only happen if the Italians play along with their government's measures and if there is no economic downturn, something that cannot be ruled out.

Of course, the major unknown is the situation in Greece, now that talks between Greek officials and private-sector creditors about a debt haircut have been indefinitely called off. In a statement released Friday, Charles Dallara and Jean Lemierre of the Institute for International Finance, the bank lobby representing private-sector bond holders in the negotiations, wrote that the discussions with Greece had been "paused for reflection."

The other 16 euro-zone countries and the International Monetary Fund (IMF) only intend to lend Greece fresh money if the banks pull their weight. And that will be the only way to prevent Greece from experiencing an uncontrolled default in March, when €17.5 billion in debt payments will come due.

Athens is pressuring private-sector creditors to agree to relinquish an even higher proportion of their claims, and the banks are calling for public-sector creditors, such as the ECB, to join in by writing off parts of their own claims. Meanwhile, hedge funds have been sabotaging every deal. With each passing day, there is a growing danger that there will either be no agreement, or that a deal is reached that isn't backed by a sufficient number of creditors.

In light of all this troubling news, Eugen Keller, a financial market expert with the Frankfurt-based private bank Metzler, predicts that demand for the sovereign bonds of southern euro-zone members will once again fall dramatically. "It's merely a matter of time," he says, "until we're back where we left off last year."

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