+--+

ECB to Intervene in Bond Market to Fight Euro Crisis (Update2) 2010-05-10 07:07:56.561 GMT

(Updates with investor comment in fourth paragraph. See {EXT3 <GO>} for more on debt crisis.)

By Gabi Thesing, Jana Randow and Simon Kennedy

May 10 (Bloomberg) -- The European Central Bank said it will buy government and private bonds as part of an historic bid to stave off a sovereign-debt crisis that threatens to destroy the euro.

The ECB wants “to address severe tensions in certain market segments which are hampering the monetary policy transmission mechanism and thereby the effective conduct of monetary policy,” the central bank said in a statement at 3:15 a.m. in Frankfurt. The announcement came less than an hour after European finance ministers unveiled a loan package worth almost $1 trillion to staunch the market turmoil.

Resorting to what some economists have called the “nuclear option,” the ECB may open itself to the charge it’s undermining its independence by helping governments plug budget holes. Four days ago, ECB President Jean-Claude Trichet said bond purchases hadn’t been discussed when members of the bank’s 22-member Governing Council met to set interest rates in Lisbon.

By deciding to “go in and buy sovereign and corporate debt, they crossed a line,” said David Kotok, chairman and chief investment officer at Cumberland Advisors Inc., which manages about $1.4 billion in Vineland, New Jersey. “The line between fiscal and monetary policy gets blurred.”

The euro jumped to $1.2982 at 8:30 a.m. in Frankfurt from $1.2755 at the end of last week.

‘Dysfunctional’ Markets

The ECB said it will intervene in “those market segments which are dysfunctional,” suggesting it views the surge in some of the region’s bond yields as unjustified and that it’s acting to stabilize markets and protect the 16-nation economy.

Investors cited the ECB’s initial refusal to consider asset purchases as one reason for the May 7 rout in global markets, which included U.S. stocks falling the most in 14 months amid concern Greece’s woes were spreading.

After a week in which markets showed growing concern about access to funding, the Frankfurt-based ECB also reversed its withdrawal of emergency steps taken to tackle the global credit crisis, saying it will again offer banks as much cash as they want for terms of three and six months. It will also reactivate a swap line with the Federal Reserve and sell unlimited amounts of U.S. currency for seven and 84 days. The first operations will take place this week.

The central bank acted in concert with governments after markets targeted European economies with the weakest public finances. The extra yield that investors demand to hold Greek, Portuguese and Spanish debt instead of benchmark German bonds surged to the highest level since the euro’s 1999 introduction.

Bunds Drop

The ECB’s strategy will hurt German bunds, lift the bonds of Portugal, Greece and Spain and eventually hamper the euro following an initial rally, said David Zervos, a managing director at Jeffries & Co. in New York.

German 10-year bonds fell when European markets opened this morning, sending the yield up 12 basis points to 2.93 percent.

While the euro’s founding treaty bans the ECB from buying bonds directly from governments, it can do so in the secondary market. The ECB said its moves won’t affect monetary policy as the resulting liquidity will be reabsorbed. The bank’s council will decide on the scope of the intervention.

“They are not cranking up the printing presses,” said James Nixon, co-chief European economist at Societe Generale SA in London. “This is a much more targeted, surgical approach.
They buy the duff stuff that no one in the market will touch.”

‘Using Every Means’

Bundesbank President Axel Weber said on May 5 that the threat of contagion from Greece’s fiscal crisis didn’t merit “using every means.” Without referring specifically to bond buying, he said “measures that damage the fundamental principles of the currency union and the trust of the people would be mistaken and more expensive for the economy in the longer term.”

The concern is that the purchasing of government debt opens the ECB to the accusation it’s coming to the rescue of fiscal authorities and may need a bailout of its own if the assets turn sour, raising questions about its independence.

An unchecked increase in the amount of money in circulation could also fan inflation, the containment of which is the ECB’s main aim.

The ECB noted that some governments had vowed to accelerate their fiscal consolidation. Spain’s budget deficit reached 11.2 percent of gross domestic product last year and Portugal’s was 9.4 percent. Greece’s was 13.6 percent.

‘Monetizing’ Deficits

“Much will depend on whether or not euro-zone governments quickly follow through on their pledge,” said Marco Annunziata, chief economist at UniCredit Group in London. “If they do not, it will be hard for the ECB to fight off the charge of monetizing excessive fiscal deficits.”

There are signs banks have started to hoard money again.

Overnight deposits with the ECB surged to a 10-month high of 290 billion euros on May 6, signaling banks are wary of lending to each other on concern about counterparties’ exposure to high-deficit countries. The rate banks say they pay for three-month loans in dollars rose the most in almost 16 months on May 7.

While European banks had claims on Greece totaling $193.1 billion at the end of 2009, that number is dwarfed by their $832.3 billion exposure to Spain and the $240.5 billion with Portugal, according to data from the Basel, Switzerland-based Bank for International Settlements.

‘Decisive’ Action

Until today, Trichet had tried to convince investors that volatility in euro-region markets would subside once the Greek government drew on its 110 billion-euro aid package and implemented its agreed austerity plan. After the May 6 meeting of the ECB’s council, he urged other European governments to take “decisive” action on deficits and said Portugal and Spain were “not Greece.”

With the roots of the current crisis lying in fiscal policy, Trichet has had less of a say in fighting the turmoil. Politicians ignored his pleas for a fast aid package and his advice that the International Monetary Fund not be included in any rescue of Greece.

His role began to shift last week when the ECB broke a commitment not to assist individual countries, saying it would indefinitely accept Greek government debt as collateral regardless of its credit rating. Trichet is today set to talk to reporters after chairing a meeting of central bankers in Basel.

For Related News and Information:
Search for central bank stories: NSE MONETARY POLICY <GO> Stories on ECB interest rates: STNI ECBACTION <GO> Stories related to the ECB: NI ECB <GO> Euro/dollar exchange rate graph USEU <Curncy> GP D <GO> Euro-region economic stories: TNI ECO EUROP <GO>

--With assistance from Meera Louis in Brussels and Klaus Wille in Basel, Switzerland. Editors: Andrew Barden, Matthew Brockett

To contact the reporters on this story:
Gabi Thesing in Brussels at +44-207-6732153 or gthesing@bloomberg.net;
Jana Randow in Basel, Switzerland at jrandow@bloomberg.net.
Simon Kennedy in Paris at +33-1-5530-6290 or skennedy4@bloomnerg.net

To contact the editor responsible for this story:
John Fraher at +44-20-7673-2058 or jfraher@bloomberg.net