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Europe acts to rein in its debt crisis

Central bank promises to buy the bonds of troubled countries, says there's no going back on the euro.

By Don Lee and Henry Chu, Los Angeles Times
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The European Central Bank unveiled an aggressive plan to buy the bonds of financially flailing countries such as Spain and Italy, its boldest step yet to stanch the continent's 3-year-old debt crisis and one that could lift the U.S. and the global economies.

The bond-buying plan unveiled Thursday is intended to stimulate economic growth by reducing the borrowing costs for cooperating Eurozone governments. But its ultimate purpose is to set up a financially adequate and politically acceptable way of containing the crisis and maintaining the survival of the euro currency.

Not all analysts were convinced that the new program was a big leap forward.

Greece's situation remains volatile, fundamental flaws exist in the 17-nation Eurozone's political institutions, and Germany's high court could throw a wrench into the ECB's effort when it rules next week on whether certain aspects of the financing plan are compatible with German law.

Still, many experts and investors regarded the announcement as a significant step in the right direction. And they expected that it would be approved by Germany, despite that nation's long reluctance to allow the central banker to act as a lender of last resort.

U.S. stocks surged Thursday as investors got an additional boost from positive signals on the American job market before Friday's important employment report.

All three major stock indexes closed at their highest levels in years, stretching back to the beginning of the Great Recession for the Standard & Poor's 500 and the Dow Jones industrial average.

"There is enough here [for the ECB] to assure investors in Europe and around the globe that the Eurozone is here to stay and there's no reason to flee the region," said **Bernard Baumohl, chief global economist at the Economic Outlook Group.** "I think it's going to work."

In announcing the plan, ECB President Mario Draghi was making good on a pledge in July that the central bank would do whatever it takes to preserve the euro.

He said Thursday that bold intervention was necessary to relieve undue pressure on governments facing high borrowing rates that weren't warranted and that raised the risks of default and a messy debt-induced death for the euro.

"Let me repeat ... the euro is irreversible," Draghi declared in Frankfurt, Germany, the city where the ECB's headquarters is located. "There is no going back to the lira or the drachma or to any other currency. It is pointless to bet against the euro."

Spanish 10-year government bond yields fell sharply after the announcement, to below 6% for the first time since May. Italian yields also edged lower, as did Greek, Portuguese and Irish yields.

The ECB's bond-buying program doesn't directly address the financial strains in Greece, which is receiving emergency funds even as Athens is struggling to meet certain economic and fiscal conditions of the bailout.

But the biggest fear among investors hasn't been so much what happens in Greece, but whether its problems would spread to the much larger Spain and Italy, economies that are too big to bail out and substantially more risky for the Eurozone's sustainability.

Now, with the ECB saying it would buy an unlimited amount of bonds of such countries, it could not only create a market of lower-priced bonds for the countries, but also assure investors that if something were to go wrong, they could sell the bonds to the ECB.

"This [plan] significantly reduces, if not eliminates, the risk of an uncontrolled scenario in the Eurozone," such as a default by Spain, said Jacob Kirkegaard, a research fellow at the Peterson Institute for International Economics in Washington.

"What we have today is not a guarantee against volatility in the euro area, but a financially adequate and politically sustainable firewall for the euro. And this is a very new and important development," he said.

The debt crisis in Europe has been a persistent head wind for the U.S. and the global economies, damping investor confidence and threatening financial instability. Europe is a major market for U.S. exports, and many American corporations have significant investments and sales in the continent.

The Eurozone economy is expected to contract this year but return to growth in 2013, with the ECB's plan boosting activity.

The central bank's action adds to the likelihood that the debt crisis "will evolve in a controlled way," said Martin Schwerdtfeger, who analyzes the global economy for TD Bank in Toronto. And that would benefit the U.S. economy.

Under the plan, the ECB would not buy bonds directly from governments at auction. The purchases would be made in the secondary market and focus on debt maturing in one to three years, but that doesn't mean the ECB couldn't buy longer-term bonds.

Draghi declined to specify exactly what would be a high enough interest rate to trigger ECB intervention to push yields down. But he put no limit on how much the bank would buy — an open-ended commitment that the ECB hopes will strongly discourage market speculation.

An earlier, more limited bond-buying spree failed to contain the crisis in part because investors simply drove up interest rates once again after it stopped.

To keep the heat on governments, however, he said that any country needing the ECB to buy its bonds would first have to agree to initiate or continue painful economic reforms and austerity cuts to reduce high deficit and debt levels. Failure to do so would result in their being cut off from the bond program.

Many analysts believe that Spain is close to asking the ECB to step in. At a news conference with German Chancellor Angela Merkel in Madrid, Spanish Prime Minister Mariano Rajoy declined to say whether he would make such a request.

European stock markets soared after Draghi's announcement, though such major gains quickly evaporated on previous occasions when Europe's leaders had unveiled efforts to shore up their monetary union.

Azad Zangana, European economist for Schroders in London, said the new program would provide short-term relief for struggling nations but would not remove all fears that Spain and Italy will eventually need full-scale rescue packages that their neighbors can scarcely afford.

"The ECB has taken another step in the right direction," Zangana said. "However, the capacity of the ECB and European governments to bail out Spain and Italy is seriously lacking."

Concern had mounted in recent days over the scope of Draghi's new battle plan, especially after reports that the head of Germany's Bundesbank, the most important national central bank in Europe, had threatened to resign if the ECB undertook large-scale bond-buying.

Jens Weidmann, the Bundesbank president, warned that unrestrained purchases would go beyond the ECB's mandate of controlling inflation, and he publicly compared bond-buying to drug addiction for troubled governments.

Draghi acknowledged such objections Thursday. But he said that the euro crisis had made the ECB's task of reining in inflation through regular mechanisms more difficult, making the bond-buying program necessary.

"We act strictly within our mandate to maintain price stability over the medium term," he said.