Merkel, Monti Lead Diplomatic Push as Draghi’s Plan Emerges

By Andrew Frye - Sep 4, 2012

European leaders are stepping up shuttle diplomacy this week as they brace for their central banker’s plan to defend the euro from bond-market turmoil.

European Union President Herman Van Rompuy is traveling to Berlin for talks with German Chancellor Angela Merkel today as Italian Prime Minister Mario Monti welcomes French President Francois Hollande to Rome. They were all given a hint about what may be in store when European Central Bank President Mario Draghi told officials yesterday he would be comfortable buying three-year government bonds to bring down borrowing costs for nations in financial distress.

The stewards of the single currency, who have sparred as borrowing costs diverged in the 17 nation-euro area, have a chance to fall in line behind Draghi. Merkel, whose country shoulders the largest cost of bailing out weaker governments, has indicated she would back a more active crisis-fighting role at the ECB and yesterday told a crowd of beer drinkers in Bavaria that Germany must show solidarity with Europe.

“I think there is broad agreement among these people,” said Luca Jellinek, head of European interest-rate strategy at Credit Agricole Corporate & Investment Bank in London. “Many people are realizing that monetary policy is broken in Europe, badly broken.”

Outlook Cut

The euro traded near a two-month high against the dollar today, gaining 0.2 percent versus the greenback and 0.3 percent against the yen as of 1:02 p.m. in Tokyo. The European Union’s debt-rating outlook was earlier cut to negative by Moody’s Investors Service.

Leaders are back from summer vacation and facing what Merkel called a “very ambitious agenda” this month to quell what has been a three-year sovereign debt crisis. Talks haven’t always gone smoothly, as Merkel and Monti clashed last week in Berlin over details while agreeing on the broad principles of collective action. Monti has pushed for flexibility on market intervention, while Merkel has focused on budget rigor.

“We have to press for reforms in other countries even if they sometimes say we’re hard-line,” Merkel said to a packed beer tent in the town of Abensberg, northeast of Munich. “It’s not enough just to keep muddling through. But I also say that in such a difficult phase these countries deserve our solidarity and that we root for them to overcome their difficulties.”

Bond Yields

The yield on Italian 10-year bonds declined 8 basis points yesterday to 5.77 percent. That was still 439 basis points more than the yield on similar maturity German bunds. Spain’s 10-year bond yields ended at 6.85 percent, near the 7 percent level that led Greece, Portugal and Ireland to seek bailouts.

Draghi told lawmakers in a closed-door meeting that purchasing short-dated bonds doesn’t constitute state financing, according to Jean-Paul Gauzes, a member of the European Parliament. “He thinks it’s not a violation of the treaty and you can do it under the current legal framework,” Gauzes said. “He said for example three years is OK, 15 years no.”

Draghi may give more details on the bank’s bond buying plans when he holds his first press conference after the summer break on Sept. 6. That day Monti will meet with European Commission President Jose Barroso, and Merkel will travel to Madrid to talk with Spanish Prime Minister Mariano Rajoy. Leaders are also awaiting a report from the so-called troika overseeing a Greek bailout, and a German court ruling on the constitutionality of the European Stability Mechanism, the region’s permanent bailout fund. That court case has delayed the start of the ESM, initially set for July.

German Finance Minister Wolfgang Schaeuble said yesterday he was very sure the ESM will come into force.
German Support

Draghi still faces challenges in winning support among the German public for market intervention. Germany reiterated its support yesterday for Bundesbank President Jens Weidmann yesterday, following reports last week that he had considered resigning over his opposition to ECB bond purchases. Schaeuble warned investors not to expect too much from the ECB plan.

“We have to be very careful that we don’t raise false expectations,” Schaeuble told Deutschlandfunk radio yesterday. “It has to remain very clear, state debt can’t be financed through monetary policy. Therefore we can’t have a decision -- we would think it very wrong -- that’s not covered by the ECB mandate.”

Monti, who raised taxes and cut spending to improve Italy’s finances, has shifted his focus to stimulating the stagnant economy and found an ally in Hollande. The French president is facing pressure at home following a summer break in which, according to a Viavoice poll, unemployment rose and his popularity fell seven points to 55 percent.

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