Trichet Prepares Draghi to Use Tools in ECB Box

By Gabi Thesing - Sep 8, 2011

European Central Bank President Jean-Claude Trichet is clearing the decks for Mario Draghi to step up the fight against Europe’s worsening debt crisis.

“If it remains a market crisis, the ECB may just give banks more liquidity but if it spreads to the real economy, they may even cut rates,” said Chris Scicluna, deputy head of economic research at Daiwa Capital Markets Europe in London. “If things get bad enough, Draghi’s first job in November may be to cut rates. Trichet prepared the ground for it.”

Trichet, 68, yesterday left the door open for the ECB to reverse its interest-rate increases earlier this year and add new emergency liquidity lines to the euro region’s crisis-hit banks. After last month expanding its bond-purchase program to include Spain and Italy and offering banks emergency cash for six months, Trichet acknowledged that the economic outlook has since worsened and inflation risks have eased.

The euro dropped the most in a month and German 10-year bund yields fell to a record as investors speculated the ECB could cut the benchmark from 1.5 percent or open up more emergency funds for banks. The economic outlook for Draghi, 64, when he takes over at the helm of the ECB in November, looks very different to the one when he emerged as the front runner after Germany’s Axel Weber pulled out in February.

Global Recession

At the time, the Frankfurt-based ECB was preparing to raise interest rates to stem inflation and Germany, Europe’s largest economy, was in danger of overheating.

Now, Deutsche Bank AG Chief Executive Officer Josef Ackermann says current conditions remind him of those at the depth of the global credit crisis in 2008.

The sovereign debt crisis is undermining confidence in Europe’s financial institutions and driving up market borrowing costs. Stocks have slumped around the world with investors fretting about a renewed global recession and authorities in Japan and Switzerland were forced to intervene to stop their currencies appreciating.

“The combination of downside risks to growth and balanced risks for inflation leaves Draghi with a fair degree of freedom to change monetary policy when he succeeds Trichet later this year,” said Derek Allassani, an economist at National Australia Bank in London.

‘Keep Calm’

The ECB yesterday cut its 2011 growth forecast to 1.6 percent from 1.9 percent and to 1.3 percent from 1.7 percent for 2012. Inflation forecasts were left unchanged at 2.6 percent for 2011 and 1.7 percent for next year. The central bank aims to keep inflation just below 2 percent.

While Morgan Stanley chief European economist Elga Bartsch in London said a rate cut could come as soon as Trichet’s last meeting in October if downside growth risks materialize, others including Societe Generale SA Chief European Economist James Nixon said the central bank is likely to use other tools such as offering banks loans with longer maturities first.

“Now is the time for the ECB to keep their calm when all around them are losing theirs,” London-based Nixon said. “The ECB’s tool kit is fairly well established at this stage, they have that ready. They’ve got to keep what they’ve got in use and let these measures run their course.”

The 23-member Governing Council decided last month to extend unlimited allotment in its refinancing operations through the end of the year and offer banks as much money as they need in a six-month tender, an operation the ECB last used after Greece’s first bailout program was announced in May 2010.
‘Rate-Cut Bazooka’

Other central banks are turning their attention to supporting economic growth. The Bank of Canada said earlier this week there is a "diminished" need for it to raise interest rates. Sweden’s Riksbank abandoned a planned increase and the Reserve Bank of Australia signaled it's prepared to keep borrowing costs on hold.

The Bank of England will be forced to add stimulus within months, according to economists at Citigroup Inc. and Goldman Sachs Group Inc. The U.K. central bank yesterday kept its key rate at a record low of 0.5 percent and left its bond-purchase program at 200 billion pounds ($320 billion) yesterday.

Carsten Brzeski, an economist at ING Group in Brussels, said while further ECB rate increases are "off the table," a cut in the benchmark still "seems to be one bridge too far."

"Things have to get a lot worse before Draghi, being the first Italian ECB president, will draw the rate-cut bazooka," he said. "Trichet has left him with plenty of other tools."

To contact the reporter on this story: Gabi Thesing in London at gthesing@bloomberg.net

To contact the editor responsible for this story: Craig Stirling at cstirling1@bloomberg.net