Stock Market Review

Mario Draghi's plan to rescue the euro

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At a conference in London on July 26, the president of the European Central Bank Mario Draghi quelled market fears by pledging that the ECB would "do whatever it takes to preserve the euro". Mr Draghi also assured critics by saying that "believe me, it will be enough".

Markets reacted positively to the sudden declaration by the head of the ECB with the 10-year bond yields of Italy and Spain easing and equity markets rallying across the world. However, this unexpected declaration also placed significant pressure on the ECB to announce its concrete plans to stem the eurozone crisis and there were high hopes that immediate action would be announced at the August ECB meeting. As such, the attention in the early part of last week was firmly fixed on the ECB's meeting on Thursday afternoon for details of the plans in this respect.

Shortly after last Thursday's ECB meeting when a decision was taken to keep the benchmark interest rate unchanged at 0.75 per cent after having cut rates by 25 basis points a month earlier, Mr Draghi explained that the plan to conduct bond purchases was conditional upon commitments by governments to carry out reforms and get their public finances back in shape.

The statement by the ECB was met with particular disappointment as the outcome fell short of expectations. Equity markets dropped suddenly on the news that the ECB had not yet formulated the finer details of their response to the crisis. Likewise, yields in the riskier eurozone nations spiked once again and the euro dropped back towards its two-year low against the US dollar. The worst affected markets were naturally those in Italy and Spain – the third and fourth largest economies in the eurozone – which are having to pay very high rates of interest to finance their borrowing requirements.

The ECB's plan requires troubled governments to formally request intervention from either the European Financial Stability Fund or the European Stability Mechanism. Once direct intervention is requested, and each government is asked to comply with its respective bailout conditions for fiscal consolidation, the rescue fund would purchase the debt that is required on the primary market while the ECB would purchase government bonds on the secondary market.

Acquisitions of bonds by the ECB falls under the Securities Markets Programme which has so far conducted purchases of over €200 billion since May 2010, principally composed of bonds from the five GIIPS – Greece , Ireland, Italy, Portugal and Spain.

President Draghi confirmed that the ECB would be drawing up plans for potentially unlimited intervention across the bond markets to lower what he termed "unacceptably high" sovereign bond yields for some eurozone countries. Clearly, reference was being made to Spanish yields which surged to a record high of 7.52 per cent in July and Italian yields which surpassed the 6.50 per cent level.

Mr Draghi argued that the latest measures to stem the crisis will be different to the purchases so far conducted by the Securities Markets Programme. In the previous interventions, the ECB insisted not to participate in the restructuring of Greek government debt, effectively placing other bondholders in a subordinated position. The ECB president, however, stated that if the ECB were to carry out market purchases under this proposed plan "the concerns of private investors about seniority will be addressed".

Draghi's plan however depends on the leaders of the eurozone to activate the two bailout funds (the EFSF and the ESM) and the greatest uncertainty to date is the opposition within the German government to the idea. At the same time of the ECB press conference, the prime ministers of Italy and Spain were meeting in Madrid. Following Draghi's statement, both governments gave no immediate signal that they would be prepared to accept the conditions that would be imposed by the EFSF. Italy's prime minister Mario Monti also said he was unsure whether Italy would request help to reduce its bond yields and announced that such a decision was still premature.

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Aside from the bond purchase plan formulated by Mr Draghi, the ECB may consider other options to stem the eurozone crisis. An obvious policy tool for any Central Bank would be to lower interest rates. At the July meeting, the ECB reduced rates to a new record low of 0.75 per cent and lowered its deposit rate to zero in an attempt to stimulate inter-bank lending. Although there remains room for further rate reductions, this measure would be somewhat limited in the context of current developments.

An alternative would be to carry out another liquidity boost through a further tranche of the long-term refinancing operation following the €1 trillion so far. However, the most dramatic decision, according to some market commentators, would be for the ECB to grant a banking licence to the permanent bailout fund, the ESM. This would allow the ESM to borrow from the ECB and take on a role as a "lender of last resort" for the sovereigns facing difficulty in raising sufficient funds from the market. However, last Thursday Mr Draghi ruled out granting a banking licence to the ESM, possibly in view of the strong opposition by the German Central Bank and other eurozone members.

Although the August ECB meeting may have disappointed the markets with no immediate action plan being launched, Mr Draghi was adamant that the ECB was prepared to intervene to reverse the market forces that were fuelling fears of a eurozone breakup. The ECB's conditional support placed the onus back on the eurozone governments to resolve the crisis.

As such, until the finer details of the ECB plan are announced and it is set in motion, the markets are unlikely to stabilise and will probably remain jittery and volatile. Markets rebounded quickly last Friday after Thursday's sell-off following the ECB meeting press conference as investors seem to have shrugged off the initial disappointment. Irrespective of the market volatility, the ECB announcement must have placed increased pressure on Spain and to a lesser extent also on Italy to officially request a bailout to kickstart Draghi's plan in what some claim to be a definitive turning point in the crisis.