# Draghi Lured by Fractious EU Leaders to Build Bridge to Euro 2.0

The European Union's 19th crisis summit was winding down when European Central Bank President Mario Draghi made an unusual request. He wanted some alone time with EU President Herman Van Rompuy to thank him for charting the path toward a shock-proof euro zone. Only later did the significance of the blueprint sketched out at the June summit in Brussels emerge. The commitment to tighter bank supervision, budget coordination and a nebulous "political union" was instrumental in persuading Draghi that governments are putting the currency on a sounder footing, leading to yesterday's ECB decision to buy bonds to help them get there. "We need two legs," Draghi said in presenting the new tactics. "Governments have to undertake the policy reforms. There is no intervention by the central bank, by any central bank, that is actually effective without concurrent policy action by the governments." While it relaunched the crisis management after 2 1/2 years of trial-and-error and bickering between creditor and debtor governments, the ECB's strategy bore traces of the compromises and half-measures that continue to gnaw at the currency union. The next moves are out of the bank's control. They depend on decisions in places like Madrid and Rome. And the leaders of the 17 governments locked into the supposedly unbreakable euro don't yet have a roadmap for remaking Economic and Monetary Union, only a pledge to come up with one. Work in Progress Like much of the anti-crisis diplomacy since a newly elected Greek government woke up to a 20 billion-euro ($25 billion) cash shortage in October 2009, the ECB announcement amounted to a work in progress, at risk of lagging behind the breakneck speed of financial markets. For now, investors were encouraged. The Stoxx Europe 600 Index (SXXP) rose 2.3 percent yesterday. Ten-year Spanish bond yields fell 38 basis points to 6.03 percent, a three-month low. Ten-year Italian yields dropped 25 basis points to 5.26 percent, a five-month low. Political leaders and central bankers have "fully signed up to some kind of medium-term United States of Europe," Jim O'Neill, chairman of Goldman Sachs Asset Management, said in a Bloomberg Television interview in London yesterday. The ECB is "telling us the markets should not keep worrying about the risk of a euro breakup and we will do things to enforce that reality." Sleepless Summit As recounted by European officials, the origins of the ECB's move lay in the sleepless summit at the EU headquarters on June 28-29. The arrival of Socialist Francois Hollande as France's president shifted the balance of power, diluting the austerity-first recipes preached by Chancellor Angela Merkel of Germany, the euro area's largest economy and chief backer of 486 billion euros in emergency loans so far awarded to Greece, Ireland, Portugal and Spain. With the broader economy slipping toward recession, Hollande's pro-growth push found a ready audience, even in Germany. A "compact for growth and jobs" was quickly approved, featuring 60 billion euros of additional lending by the EU's investment bank. The rest of the meeting didn't go according to plan. Breaking with his predecessor Nicolas Sarkozy's fealty to the German agenda, Hollande supported pleas by Spain's Mariano Rajoy and Italy's Mario Monti for immediate relief from runaway borrowing costs. Merkel's Order What resulted was a microcosm of the cliffhanger politics that have marked the crisis. Merkel ordered her people to boycott a senior officials meeting, held across from the city's best-known French fry stand, Maison Antoine, to discuss technical ways of aiding Spain and Italy. The German objection was that when the leaders are in town, no one else counts. Only when the aides trooped up the road to join the summit entourage did Germany take part. After heads of non-euro countries went to bed, the euro leaders soldiered on through the night, concocting a pledge to use existing bailout funds "in a flexible and efficient manner." As the sun rose, Monti declared victory, basking in the promise of aid with few strings attached; in response, Merkel told German television cameras that she hadn't yielded. Lost in the rhetorical fog was the payoff from months of efforts by European officials to woo the independent ECB, bringing it closer to the lender-of-last-resort role played by the U.S. Federal Reserve and Bank of England. For starters, there was last December's deficit-limit accord, which helped encourage the ECB to lend an unprecedented 1 trillion euros to banks to unclog the credit channel. Draghi's Role Draghi, praised by Brussels insiders for his long-term thinking, wanted more from the governments, and got it. The central banker was invited to join Van Rompuy, European Commission President Jose Barroso and Luxembourg Prime Minister Jean-Claude Juncker, the chairman of euro finance meetings, in laying out a 10-year route to a better-run economy. Presented at the summit, the four presidents' report called for tighter banking supervision, integrated fiscal management with possible joint debt issuance and more central economic policymaking, all flanked by closer oversight by the European and national parliaments. It looked a lot like the unified political system that German central bankers had always said was needed to underpin the euro. "I'm actually quite pleased with the outcome," Draghi said on his way out of the summit. "It showed the long-term commitment to the euro by all member states of the euro area, but also it reached tangible results in the shorter term." 'Various Opinions' The risk was that the idealized vision would be undercut by the same conflicts between north and south that have let the debt crisis drag on. Germany led the charge against euro bonds. "Various opinions were expressed," the final communique said. A December 2012 deadline was set for "a specific and time-bound roadmap" to work out the basics of a new-look euro zone. EU treaty changes, which took eight years the last time out, would be on the table again. A post-summit rally in Spanish and Italian bonds petered out once it became clear that the taxpayer-financed rescue fund, with as little as 140 billion euros left, wasn't rushing in. Spain's extra 10-year borrowing cost over German levels peaked at 638 basis points and Italy's at 536 basis points on July 24. Once again, it would fall to the ECB, with its potentially unlimited resources, to buy time. Yesterday's ECB market-support declaration left blanks to be filled in: on the timing and size of the bond purchases and whether the conditions would be palatable for Spain and Italy, the two likeliest beneficiaries. Rajoy's Stall "When I have anything new to tell you, I will say so," Rajoy told reporters yesterday after meeting Merkel. "For the moment I haven't even had the time to read about Mr. Draghi's intervention." Speaking in Frankfurt, Draghi made clear that ECB's unconditional -- and later aborted -- purchases of Spanish and Italian bonds in 2011 wouldn't be repeated. "We designed a parcours, a road, and it's in the hands of the governments," Draghi said. Both countries are squirming to escape additional budget cuts. The scene now shifts to negotiations between Spain and Italy and the euro creditor countries, led by Germany. Finance ministers next meet on Sept. 14 in Cyprus, which itself is in talks that would make it the fifth country to tap a financial lifeline. Bundesbank Dissent The ECB's 22-1 vote in favor of the bond-buying policy appeared overwhelming except that the dissenter was Jens Weidmann, head of Germany's Bundesbank, which set the gold standard for central banks in the pre-euro era and is the ECB's weightiest component today. As a result, a key part of the Euro 2.0 deliberations will play out within the central bank itself. It is now time, Draghi indicated, for the ECB to graduate from the narrowly inflation-focused priority rooted in the German model and assume greater responsibility for the functioning, or even the survival, of the system. Away from the crosstown Frankfurt duel between Draghi and Bundesbank, events on Sept. 12 will illustrate what else could go wrong. In the morning, the German supreme court will rule on the constitutionality of the planned permanent rescue fund, potentially upsetting Germany's more than half-century pursuit of European unity; at lunchtime, the EU commission will lay out its proposals to put the ECB at the heart of continent-wide banking supervision, already questioned in Germany; and at sundown, polls close in an election in the Netherlands after a campaign marked by calls for more spending at home and less on fiscally irresponsible neighbors. "The difficulties involved in creating a more balanced and more effective system of democratic control are formidable, but it would be foolish to bank on failure," said Peter Ludlow, a Brussels-based historian and author of "The Making of the New Europe." "The pressure for reform is already considerable and is likely to grow rather than diminish."