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Revamped ECB Lending Rules May Give Greece More Pain Than Gain
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By Frances Robinson

April 8 (Bloomberg) -- The European Central Bank's decision to change its lending rules may end up hurting debt-laden Greece more than helping it.

While President Jean-Claude Trichet last month assisted Greece by extending the ECB's emergency collateral rules into next year, the move may come at a cost. The new framework will make it more expensive for banks to exchange Greek bonds for central bank funds because of their lower credit rating. Since the ECB loosened its rules during the financial crisis, two of the three main ratings firms have cut Greece's rating below the minimum required under the old regime.

"There's now hardly any chance of Greek debt becoming ineligible at the ECB," said Nick Kounis, chief European economist at Fortis Bank Nederland NV in Amsterdam. "But the new collateral system will certainly be less favorable to countries with lower ratings, especially Greece."

The ECB's Governing Council meets today as Greece's fiscal crisis shows no sign of abating. The extra yield investors demand to hold Greek 10-year bonds instead of Germany's yesterday soared to the highest since the euro was introduced in 1999. That's complicating the ECB's efforts to withdraw emergency stimulus measures used to nurse the euro-region economy through its worst recession since World War II.

All 62 economists surveyed by Bloomberg News expect the ECB to keep its benchmark interest rate at a record low of 1 percent. It announces the decision at 1:45 p.m. in Frankfurt and Trichet briefs reporters 45 minutes later.

Graded Haircuts

Trichet has promised to reveal details of the bank's new collateral framework, which includes a proposed "graded haircut schedule."

A haircut is the risk premium central banks apply to securities they accept as collateral against loans. A 10 percent haircut on an asset means the central bank would lend commercial banks 90 percent of its value. The ECB is proposing to apply bigger haircuts to assets with lower credit ratings.

Had the ECB stuck to its plan to revert to pre-crisis rules at the end of the year, Greek bonds would have become ineligible in refinancing operations in the event of Moody's Investors Service cutting its rating two notches to a level comparable with other agencies. Greece is rated A2 at Moody's, while Standard & Poor's and Fitch Ratings both have a BBB+ rating on the country's debt.

'Poor Collateral'

"Soon, due to its poor credit rating, Greek debt will be treated like poor collateral, so banks will no longer be able to borrow as much with Greek debt as collateral,” Simon Johnson, Professor of Finance at the Massachusetts Institute of Technology and a former International Monetary Fund chief economist, wrote in the Huffington Post yesterday. “When these changes at the ECB come into effect in 2011, the days of Greece being able to borrow easily at low interest rates in the euro zone will close once and for all.”

Greece is struggling to cut its budget deficit from 12.7 percent of gross domestic product, prompting investors to dump Greek assets amid speculation the country could default on its debts.

The spread between Greek 10-year bonds and the German equivalents rose to 407 basis points yesterday. The average gap over the past decade was 34 basis points. Concerns about the country’s creditworthiness have affected the bonds of Spain and Portugal, whose budget deficits have also ballooned.

Some economists say the ECB will be wary of tightening lending rules for countries that are struggling to convince investors they can cut their budget shortfalls.

Helping Hand

“You don’t want to kill these guys while they’re struggling to put the house back in order,” said Silvio Peruzzo, an economist at Royal Bank of Scotland Group Plc in London. “Pre-announcing the collateral rule changes clearly suggests they are working toward helping countries which are struggling with fiscal consolidation.”

Laurent Bilke, a former ECB economist now with Nomura International Plc in London, said the ECB could “sterilize” the haircut changes by lowering the premiums determined by other criteria, such as maturity. “To avoid penalizing Greek government bonds excessively, we see only small scope for a hawkish outcome in which haircuts are broadly increased from current levels,” he said.

Greece needs to raise 11.6 billion euros in funding by the end of May to meet debt repayments coming due in the next two months, and will need to raise another 20 billion euros ($27 billion) by the end of the year to finance its deficit.

Tighter ECB collateral rules would make that borrowing more expensive, said Erik Nielsen, chief European economist at Goldman Sachs Group Inc. in London.

“As Greece will continue to need its banks for roll-overs and deficit financing, the cost of providing that financing is almost certain to go up,” he wrote in a note to clients. “Probably unintentionally,” the ECB’s new rules “may be very painful for Greece and its banks.”

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