Has the ECB got the guts?

IF THE EUROPEAN CENTRAL BANK IS SERIOUS ABOUT BACKSTOPPING BONDS, SAYS **MARK GILBERT**, THEN THERE IS ONE SURE-FIRE WAY TO RESOLVE THE EUROPEAN DEBT CRISIS.

Europe's debt crisis is getting worse, not better. The European Central Bank's milquetoast bond-buying efforts have done diddly and squat to prevent borrowing costs from soaring to levels that mean each new sale of securities drags euro-region governments closer to the bankruptcy courts. All policymakers have done is distort the bond market, making it impossible to judge what investors truly regard as the appropriate borrowing cost for indebted euro members.

If the ECB is serious about backstopping bonds – and that's a big if, since it's pretty easy to envisage the Frankfurt crowd cheering yields higher with "Go, baby, that'll teach them for their fiscal indiscipline!" – then tinkering at the edges by bidding for a Greek bond here, an Irish security there, isn't the way to go.

Instead, the central bank should expand its armoury to include the most potent weapon the sorcerers of financial alchemy have concocted to date. By crying havoc and letting slip the dogs of derivatives, European policymakers could prove their commitment to averting default, restoring some sense of order to the government bond market and maintaining the integrity of the common currency project.

GUARANTEEING TO INDEMNIFY BONDHOLDERS WOULD PUT THE ECB'S MONEY WHERE FINANCE MINISTERS' MOUTHS ARE.

Credit default swaps, decried as weapons of financial mass destruction by governments that aren't keen on having their economic indiscipline turned into fodder for financial gambling, could be employed as a battering ram to bludgeon the bond vigilantes. By offering insurance against a failure to pay through the sale of default swaps to anyone who wants to buy, the ECB could stand in the market and change the price of money. By offering unlimited insurance, the ECB could drive down the cost of swaps with each successive trade it does with a default-wary bondholder or pesky naked-short-selling speculator (depending on your viewpoint). It would be a neat way of turning the tables on those who would seek to profit from the euro's fiscal shortcomings.

A basis point on a credit default swap protecting 10 million euros of debt from default for five years is equivalent to €1,000 a year. Swaps pay the buyer face value in exchange for the underlying securities or the cash equivalent, should a borrower fail to adhere to its debt. Buyers of swaps don't need the underlying borrower to default to make money; they just need other traders to agree that creditworthiness is deteriorating, boosting the value of the insurance contract and allowing the holder to sell at a profit.

Underwriting euro-region debt by offering cash protection against non-payment via the tried and tested mechanism of default swaps could be a game-changing vote of confidence in the ability of the euro nations to keep their debt promises. Guaranteeing to indemnify bondholders would put the ECB's money where finance ministers' mouths are. That way, instead of the likes of Germany and France proclaiming that a euro-member reneging on debt obligations is unthinkable, they'd have some real skin in the game of keeping Greece, Ireland and the other high-deficit countries on the straight and narrow.

Of course, it will never happen. Joint and several guarantees are anathema to Germany, which still has the tiller of the good ship Euro. Putting German taxpayers on the hook in the derivatives market would be a hard sell to voters already wary of propping up their profligate neighbours. The ECB, meantime, is already up to its eyeballs in trashed euro debt as it tries to cap surging yields; a default swap programme would expose it to billions more euros in potential losses.

The only stick beating Germany into line on the bailout packages is the dread that its banks will be left holding worthless government paper, should Greece and Ireland and their fellow overextended borrowers fail to make good on their debt commitments. If its leaders continue to badmouth bondholders, no amount of central bank support will prop up debt prices.

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