

EURO BRIEFING NOTE – 1 August 2011 – PART TWO

LEARNING FROM THE PAST IN MONETARY UNION SAGA

By David Marsh

History lesson 1 - Method behind Merkel as Chancellor takes lead from Helmut Kohl

The euro is in many ways heir to the Roman Empire, an experiment both noble and improbable in its vaunting ambition. The realm is united not by the might of legionnaires but by the all-encompassing power of money, directed by the battalions of the European Central Bank in Frankfurt. Yet no Caesar is in charge. One politician who might have emerged as commander-in chief, German Chancellor Angela Merkel, has shown no signs of imperial grandeur. Instead, she has been conspicuous by a strong tendency towards dithering, habitually being pressed into 11th hour action by France's mercurial President Nicolas Sarkozy.

Yet there is method behind Merkel's apparent indecisiveness. The history of previous monetary battles between France and Germany suggests that, like many emperors before her, the German Chancellor sees merit in biding her time. During the run-up to the 21 July summit, Chancellor Merkel irritated the European Commission by declaring she would not turn up at the meeting unless there was a firm prospect of a deal. Playing down the euro drama as a way of persuading other countries to make compromises has been a constant feature of Merkel's tactics over the past 18 months – even though it is mixed, somewhat confusingly, with her over-blown statements that the 'future of Europe' is at stake.

This mirrors the behaviour of Merkel's predecessor-but-one, Chancellor Helmut Kohl, who – during a deeply perturbed period for financial markets - arrived for a long-scheduled meeting at the Elysée Palace in Paris on 22 September 1992. Kohl found President François Mitterrand in a highly nervous state, telling the visiting Chancellor that the French franc was coming under massive speculation on the foreign exchanges.

Unless the independent Bundesbank stepped in to help, Mitterrand informed Kohl France would have to leave the European Monetary System, the semi-fixed rate scheme that was the forerunner of EMU. Evoking memories of the Second World War, Mitterrand told Kohl the French could hold out for three days but would then have to surrender. 'The Bundesbank would be 'the last one standing on a field of ruins,' he said, according to French presidential transcripts.

Kohl reacted with initial aloofness, a government leader concerned with high-flying affairs of state far removed from day-today financial market banalities 'I'm surprised by your dramatic tone. People told me yesterday everything was calming down.' The drawn-out narrative ended with Germany taking action to rescue the French franc – but only after the French had agreed German demands to raise interest rates.

In another parallel with Helmut Kohl, Merkel now tells interlocutors that she is heavily constrained in her leeway over EMU bail-outs by the rigid stance of the independent ECB and the Bundesbank. In similar vein, Kohl during preparatory negotiations for monetary union in the early 1990s used the Bundesbank's strict conditions as a means of toughening further the German stance on EMU.

In December 1989, shortly after the fall of the Berlin wall, Kohl told then US Secretary of State James Baker Germany was supporting EMU even though it was not in Germany's interests – saying, 'The president of the Bundesbank [Karl Otto Pöhl] is against this development.' In similar vein, 22 years later, far from being affronted by the immediate criticism of the Brussels summit accord on bailouts for Greece by new Bundesbank president Jens Weidmann, Merkel is likely secretly to be comforted by it.

The German Chancellor can use Weidmann's well-publicised stringency as a method of advancing a German line on EMU that looks likely to become more rather than less obdurate as the crisis mounts.

History lesson 2 – Deficits do matter, as Jacques de Larosière pointed out in 1975

One of the principal tenets behind the euro has long been that balance of payments deficits within EMU do not really matter too much – because they will be smoothly financed by surpluses moving in to the deficit countries from the creditor states. As the growing sovereign debt crisis has shown, the belief was always an illusion.

However, the credo was still going strong in August 2007 – the month of the bursting of the bubble in the sub-prime mortgage sector of American housing loans. The European Central Bank published a 12-page article devoted to global imbalances in current account surpluses and deficits, saying, ‘The issue is important, as a potentially disorderly unwinding could pose a risk for the global economy and the stability of the international financial system.’

The article focused on the rise in the US current account deficit ‘to unprecedented levels’ as well as on the surplus countries of Japan, China, Saudi Arabia and Russia. But it wholly failed to mention the imbalances within the euro area, on the grounds that the current account position of EMU countries had been ‘broadly balanced.’

In an unwitting prophecy of the unrest sparked by Greece just two years later, the ECB wrote in August 2007, ‘It is hard to define which countries are systemically important: some past financial crises have been triggered by relatively small economies. However, unregistered by the ECB’s statistical coverage, euro members in 2006 recorded some of the world’s largest balance of payments disequilibria.

Greece, Portugal and Spain respectively ran up deficits of 11%, 10% and 9% of GDP, while Germany and the Netherlands earned surpluses of 6.5% and 9%. In all cases, these imbalances were even larger than that displayed by the US, with a current account deficit of 6% of GDP that year.

The ECB's analysis ignored the advice back in July 1975 of Jacques de Larosière, director of the French Treasury, who later became managing director of the IMF and then governor of the Banque de France. He produced a brilliant analysis of the possible perils of premature introduction of monetary union among states that remained economically heterogeneous. He pointed to the danger that countries within a monetary union could become permanently uncompetitive and register international payments 'in permanent disequilibrium' as a result of durable divergences in productivity and prices.

De Larosière's findings, buried in archives for more than three decades, provided a clinically incisive warning of the problems that eventually hit EMU in 2010-11. Since currency adjustments within monetary union would be impossible, he wrote, 'The evolution of the exchange rate of the European currency compared with other world currencies will affect the competitiveness of member states' products in different ways. If, globally, the Community has an interest in fixing its rate of exchange at a certain rate, the interest of each member state taken in isolation could be different.'

'The creation of a European currency in no way causes the disappearance of the notion of the commercial balance and the balance of payments between member states. Some of these balances could be in permanent disequilibrium as a result of divergent evolutions in productivity and prices. A system of extremely well developed long term credits will be necessary to support these evolutions during a certain period. But such credits can hardly be permanent and growing.'

Three decades later, with the euro area in disarray, de Larosière's forecast has come to bear with full force. Unfortunately, there was little evidence of de Larosière-style prescience in the early years of monetary union. With regard to notions that balance of payments deficits would always be financeable, de Larosière's scepticism would not have come amiss.